

Canadian Securities Administrators

CSA Consultation Paper 92-401

Derivatives Trading Facilities

Canadian Securities Administrators Derivatives Committee  
January 29, 2015

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## **CSA CONSULTATION PAPER 92-401 – *DERIVATIVES TRADING FACILITIES***

On November 2, 2010, the Canadian Securities Administrators (the **CSA**) Derivatives Committee (the **Committee**) published for comment Consultation Paper 91-401 – *Over-the-Counter Derivatives Regulation in Canada (Consultation Paper 91-401)*. That consultation paper set out high-level proposals for the regulation of over-the-counter (**OTC**) derivatives in Canada. The Committee sought input from the public with respect to the proposals and eighteen comment letters were received. This public consultation paper is the seventh in a series of papers that build on the regulatory proposals contained in Consultation Paper 91-401. It proposes a framework for the regulation of OTC derivatives trading facilities in Canada.

The Committee continues to consult and collaborate with the Bank of Canada, the Office of the Superintendent of Financial Institutions (Canada), the Department of Finance Canada, and market participants. The Committee also continues to contribute to and follow regulatory proposals and legislative developments in foreign jurisdictions and to work with international regulators and bodies such as the International Organization of Securities Commissions, the Financial Stability Board and the Over-the-Counter Derivatives Regulators' Forum in the development of international standards.

Although a significant market in Canada, the Canadian OTC derivatives market comprises a relatively small share of the global market and a substantial portion of transactions entered into by Canadian market participants involve foreign counterparties. It is therefore important that rules developed for the Canadian market are aligned with international practice to ensure that Canadian market participants have access to the international market and are regulated in accordance with international principles to the extent appropriate. The Committee will continue to monitor and contribute to the development of international standards. In this context, it is hoped that this paper will generate commentary and debate that will assist the CSA in developing harmonized policies and rules that are appropriate for Canada.

## EXECUTIVE SUMMARY

At the Pittsburgh Summit held in September 2009, the G20 leaders agreed that “all standardized OTC derivatives should be traded on exchanges or electronic trading platforms, where appropriate”.<sup>1</sup>

Exchanges and electronic trading platforms are systems or facilities that bring together buying and selling interests in one or more financial instruments, leading to the execution of transactions in those instruments.<sup>2</sup> In order to implement the G20 commitment to mandate the trading of suitable OTC derivatives on exchanges or electronic trading platforms in Canada, the Committee recommends that the CSA pursue two principal outcomes:

- develop a regulatory framework for “derivatives trading facilities” (DTFs), that is, organized trading platforms for the trading of OTC derivatives;
- require suitable OTC derivatives, or classes of OTC derivatives, to trade exclusively through a DTF.

The following is a summary of the Committee’s specific recommendations in relation to pursuing these two principal outcomes.

### Derivatives trading facilities

1. **Definition of DTF:** The Committee proposes to define a DTF to mean a person or company that constitutes, maintains, or provides a facility or market that brings together buyers and sellers of OTC derivatives, brings together the orders of multiple buyers and multiple sellers, and uses methods under which the orders interact with each other and the buyers and sellers agree to the terms of trades.

OTC derivative is used in this paper in its customary sense to refer to a derivatives contract that is traded other than on a formal exchange, such as on a dealer network or directly between two parties.<sup>3</sup>

The proposed definition of a DTF is intentionally broad and would capture various multilateral execution processes and venues. However, the proposed definition is not intended to capture bilateral or one-to-many facilities such as single-dealer platforms, nor is it intended to capture facilities or processes where there is no actual trade execution or arranging taking place, such as bulletin boards used solely for advertising buying and selling interests.

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<sup>1</sup> Statement No. 13, *Leaders’ Statement: The Pittsburgh Summit* (September 24 – 25, 2009), available at [http://g20.org/wp-content/uploads/2014/12/Pittsburgh\\_Declaration.pdf](http://g20.org/wp-content/uploads/2014/12/Pittsburgh_Declaration.pdf) (the **G20 Leaders Statement**) at 9.

<sup>2</sup> Technical Committee of the International Organization of Securities Commissions (IOSCO), *Report on Trading of OTC Derivatives*, February 2011 (**IOSCO Trading Report**) at 10-11.

<sup>3</sup> However, for the purposes of this paper, an OTC derivative does not cease to be an OTC derivative merely because it may be traded on an exchange. This is important because, as discussed elsewhere, the Committee anticipates that in some jurisdictions a DTF may be recognized as an exchange.

2. ***Regulatory framework for DTFs:***

- (a) Any DTF, regardless of whether it offers trading in OTC derivatives that are mandated to be traded on a DTF, would require an authorization from the securities regulatory authority in each jurisdiction in which it operates, or an exemption from such requirement.
- (b) An authorized DTF would be permitted to provide facilities for trading in both OTC derivatives that are mandated to be traded on a DTF and those OTC derivatives not mandated to be traded on a DTF. For clarity, market participants would not be required to trade non-mandated OTC derivatives through a DTF.
- (c) DTFs generally would be regulated similarly to an exchange. For example, all DTFs would be required to have rules governing the conduct of participants, designed to ensure compliance with applicable legislation, prevent fraud and manipulative acts and practices, and promote just and equitable principles of trade.

DTFs generally would also be required—directly or indirectly through an authorized third-party regulation services provider—to monitor compliance by participants with those rules and to appropriately discipline participants in the event of non-compliance.

- (d) A DTF operator that exercises discretion<sup>4</sup> in the execution of transactions would be subject to additional requirements similar to those applicable to dealers.<sup>5</sup> Such requirements would include, for example, the duty to act fairly, honestly and in good faith, and requirements relating to proficiency of individual representatives, “know your client” and suitability, the handling of accounts, confidentiality of customer information, client order exposure rules, and best execution.

In addition, to address the potential for conflicts of interest, a DTF that exercises discretion would be required to retain an authorized third-party regulation services provider to monitor and enforce both its conduct and that of the participants on its platform.

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<sup>4</sup> Discussed at para. 7 below.

<sup>5</sup> Including those applicable to dealers under current rules and those that will be applicable pursuant to derivatives registration rules yet to be enacted; see CSA Consultation Paper 91-407 – *Derivatives: Registration*, published on April 18, 2013.

3. **Organizational requirements:** All DTFs would be subject to basic organizational requirements, comparable, to the extent appropriate, to those established for marketplaces regulated under National Instrument 21-101 – *Marketplace Operation (NI 21-101)* and National Instrument 23-101 – *Trading Rules (NI 23-101)*. Among other things, DTFs would be subject to requirements related to:
- transparency, e.g., via disclosure on a website of, among other things, fees, how orders are entered, interact and execute, order types, access requirements, technology requirements, trading requirements, including market conduct requirements, and the policies and procedures for managing conflicts of interest;
  - record-keeping and record preservation, including in respect of records of market participants with access to the trading facility, trading summaries, and records of trades, orders, and quotations;
  - publication of and fair access to trade and price information;
  - access, including not unreasonably prohibiting, conditioning or limiting access to services offered;
  - system requirements, including adequate controls over those systems;
  - business continuity planning and independent system reviews;
  - adequate financial resources;
  - personnel and outsourcing of functions;
  - addressing conflicts of interest; and
  - reporting to securities regulators.
4. **Contrast with NI 21-101:** NI 21-101 provides a regulatory framework for a number of different “marketplaces”, including securities exchanges,<sup>6</sup> alternative trading systems (ATS) and quotation and trade reporting systems (QTRS). A DTF would be distinct from the “marketplaces” currently regulated under NI 21-101. Although to the extent appropriate the rules governing DTFs will be consistent with NI 21-101, rules governing DTFs will be tailored to specifically address the organized platform trading of OTC derivatives. For example, unlike for trades executed on a marketplace regulated under NI 21-101, trades executed through a DTF would not be required to be cleared unless the derivative was of a class that had been mandated to be cleared pursuant to a clearing rule. As described elsewhere, it is also contemplated that the operator of a DTF will be permitted to exercise discretion in the manner of order execution, which is not something for which NI 21-101 provides.

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<sup>6</sup> And futures exchanges in Quebec.

5. **Existing marketplaces:**

- (a) The Committee recommends that exchanges trading derivatives that are not OTC derivatives would not be regulated as DTFs in respect of their current (non-OTC derivatives) operations.
- (b) Existing marketplaces that wished to provide a platform for trading in OTC derivatives would be required to apply for authorization to offer trading in OTC derivatives.
- (c) Depending on the products it trades, a trading platform might constitute both a DTF and a marketplace under NI 21-101. Where appropriate and possible, conflicting and duplicative regulation would be avoided, most likely on a case-by-case basis.

6. **Execution methods:** A DTF would be permitted to use a variety of execution methods, for example, continuous or periodic order book, request-for-quote, request-for-stream, voice, or hybrid voice-electronic execution methods. As discussed elsewhere in this Consultation Paper, certain execution methods may be compulsory for products that are mandated to trade on a DTF.

7. **Exercise of discretion:** The Committee is considering whether to permit the operator of a DTF to exercise a degree of discretion in the manner of executing transactions between its participants. In accordance with a DTF's rules, a DTF operator may be permitted to exercise discretion in determining, among other things, when to place an order for a participant or to retract it, which participants are contacted with requests for quote (**RFQ**), which orders or RFQs are matched with other orders or quotes, and the order and timing of such matching. In practice, discretion allows platform operators to run "hybrid systems," consisting of both electronic trading and voice broking, that allow for the periodic execution of trading interests. Such discretion enables platform operators to facilitate the pre-arrangement or pre-negotiation of transactions prior to execution.<sup>7</sup> A DTF exercising discretion would have additional requirements placed upon it, as described above. Even so, discretionary execution methods may not be permitted for products that are mandated to trade on a DTF.

8. **Pre-trade transparency:** Except in the case of derivatives that are mandated to trade on a DTF (see below), a DTF would not be required to provide a particular level of pre-trade transparency. However, if a DTF were to execute transactions in a way that inherently provides a certain degree of pre-trade transparency (as would be the case with a published order book), it would be required to do so in a manner that did not unreasonably limit access to such information by a participant or class of participants.

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<sup>7</sup> Discretion exercised by the participants themselves is not the kind of discretion that is meant here. See infra note 55.

9. ***Post-trade transparency:*** A DTF would be required to report to the public transactions executed on its facility in as close to real-time as technically feasible.<sup>8</sup> Deferred publication would be permitted in certain circumstances, such as for block trades. Additionally, DTFs would be required to provide certain market information to the general public at no charge on a delayed basis. Although not required to, a DTF would not be prohibited from disseminating real-time data.

#### **Mandating OTC derivatives to be traded on derivatives trading facilities**

10. ***Trading mandate:*** Members of the CSA, after consultation with other Canadian authorities and with the public, may determine certain OTC derivatives to be appropriate to be mandated to trade exclusively on an authorized DTF.

#### **Determining whether OTC derivatives should be mandated to trade on a DTF**

11. ***CSA review of trading data:*** Prior to requiring that any class of OTC derivative be traded exclusively on a DTF, the Committee recommends that members of the CSA review trading and clearing data covering an appropriate time period. In particular, the Committee contemplates that the CSA will wish to review the level of liquidity of OTC derivatives in the Canadian market, the current volume and turnover in derivatives of various asset classes in Canada, the number and type of market participants transacting in OTC derivatives in Canada, and the extent to which multilateral execution methods are currently being used for OTC derivatives transactions. The Committee recommends that an OTC derivative be mandated to be traded on a DTF only after trade reporting and clearing data with respect to that derivative has been analyzed for a sufficient period of time. The Committee anticipates that the trading data would be reviewed periodically with a view to considering whether additional derivatives should be added to the list of those that are mandated to trade through a DTF, and whether there are derivatives on the list that should be removed.
12. ***Factors to be considered in determining whether to mandate trading on a DTF:*** In determining whether to require a class of OTC derivatives to be traded exclusively on a DTF, the Committee recommends that the CSA consider factors including whether the class of OTC derivatives is: subject to a clearing mandate, sufficiently liquid and standardized, subject to a similar trading mandate in other jurisdictions, or already trading through the facilities of a DTF or foreign trading platform.
13. ***Pre-trade transparency requirements applicable to derivatives mandated to be traded on a DTF:*** For OTC derivatives that are mandated to be traded on a DTF, we contemplate that a DTF would be required to provide pre-trade disclosure to all users of its facilities of current bid and offer prices and market depths. We contemplate that the nature of pre-trade transparency may need to be tailored to the form of execution

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<sup>8</sup> The Committee is considering methods for public reporting of transactions; please see section 9, Post-trade transparency, in the main body of the paper below.



method.<sup>9</sup> Exemptions from pre-trade transparency requirements are contemplated for orders that, because of their size, would expose liquidity providers to undue risk.

14. ***Post-trade transparency requirements applicable to derivatives mandated to be traded on a DTF:*** For derivatives that are mandated to trade on a DTF, we do not contemplate standards of post-trade transparency that differ from the standards that would apply to all transactions executed on the DTF.

#### **Exemptive relief for a foreign-based DTF regulated in its home jurisdiction**

15. A foreign-based DTF (such as a “swap execution facility” based in the United States) that carries or would like to carry on business in Canada may apply for an exemption from the requirements that would otherwise apply to it as a DTF, where it can demonstrate that the regulation and oversight of the DTF in its home jurisdiction is comparable to that which would apply if the DTF were domiciled in Canada. In such case, the CSA members may, with respect to the day-to-day oversight of the foreign-based DTF, rely on the oversight by its home regulator; however, the ability of the regulator in Canada to engage in general oversight would be retained.<sup>10</sup> Such a DTF also might be required to fulfill reporting requirements to the regulators in the jurisdictions of Canada in which it operates.

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<sup>9</sup> E.g., for trading via RFQ, the requests and quotes are only between the requester and the interrogated dealers. As discussed below in the main body of this paper, a degree of pre-trade transparency could be provided by ensuring that the requests are sent to several dealers, and that the reply include not only quotes but any matching orders from the order book.

<sup>10</sup> CSA members might retain discretion to oversee such matters as fair access and compliance with Canadian market integrity requirements.

## SUMMARY OF QUESTIONS

The questions below appear in the order in which they appear in the main body of the paper.

### Defining “Derivatives Trading Facility”

1. Is the DTF category appropriately defined? If not, what changes are needed and why?
2. Is it appropriate to permit a DTF operator a degree of discretion over the execution of transactions? Why or why not? If discretion is permitted, should it be permitted only for trading in products that have not been mandated to trade on a DTF?

### Permitted Execution Methods

3. Is the description of permitted execution methods for a DTF suitable for facilities that currently offer or plan to offer trading in OTC derivatives?
4. Please comment on required modes of execution. Should any particular minimum trading functionality be prescribed for DTFs generally?

### Regulatory Authorization of DTFs

5. Is the proposed regulatory framework for DTFs appropriate?
6. Is it appropriate to impose dealer requirements on a DTF where the operator of the DTF exercises discretion in the execution of transactions? (Please explain.) If so, should such a DTF be required to register as a dealer, or should only certain dealer requirements be imposed on the DTF? (Which ones?)
7. To address conflicts of interest, should a DTF that exercises discretion in the execution of transactions be required to exercise this functionality in a separate affiliated entity? Why or why not?
8. What factors are relevant in defining the proposed best execution duty?

### Organizational and Governance Requirements

9. Is it appropriate to allow a DTF to require clearing of all trades on the DTF that are capable of being cleared?
10. Is it appropriate to allow a DTF to require transactions executed on its facility to be cleared through a particular clearing agency and/or reported to a particular trade repository?
11. Is it appropriate for a DTF that exercises discretion in trade execution to be permitted to limit access to its facility? If so, on what grounds should it be permissible?

12. Are the proposed organizational and governance requirements for DTFs appropriate? Are there additional organizational and governance requirements that the Committee should consider?
13. Is it appropriate that a DTF that does not exercise execution discretion be permitted to perform its regulatory and surveillance functions itself, or should it be required in all cases to engage a third-party regulation services provider for this purpose? Please explain.
14. Do you agree with the proposal to prohibit DTF operators from entering into trades on their platforms as principals, on their own accounts? Please explain.
15. How should the sufficiency of a DTF's financial resources be evaluated? Please comment on the methodology and frequency of the calculation.

### **Pre-trade Transparency**

16. Should pre-trade transparency requirements apply to OTC derivatives that trade on DTFs but that have not been mandated to be traded on DTFs? If yes, what requirements should apply, and should any exemptions be provided?

### **Post-trade Transparency**

17. Are the proposed post-trade transparency requirements (involving real-time trade reporting as well as public reporting of certain daily data) appropriate for DTFs?
18. What is the preferred method for real-time public reporting of transactions executed on a DTF (i.e., directly by a DTF, via trade repositories, or some other method)? What are the advantages and disadvantages of the proposed options?
19. When should deferred publication of trade information be permitted? Are there circumstances other than block trades?
20. Assuming that deferred publication of trade information should be permitted for block trades, what criteria should be considered when determining the minimum block trade threshold size to permit deferred trade disclosure?
21. What market information should a DTF be required to provide to the general public without charge, and on what schedule? Please be as specific as possible as to data elements, granularity, and schedule (compare with the US CFTC rules in 17 CFR 16.01).
22. In addition to reporting trade information to a trade repository, should a DTF be required to disseminate trade information directly to all its participants, or only to the counterparties to the trade? Should there be a minimum amount of post-trade information

that is disseminated to all participants, containing less detail than the information provided to the counterparties? Please specify.

### **Trading Mandate**

23. Are the proposed criteria for determining whether a derivative will be subject to a DTF-trading mandate appropriate? Should other criteria be considered?
24. Are there existing OTC derivatives that should be considered suitable for mandatory trading on a DTF? Are there classes of OTC derivatives for which a mandatory trading obligation would be detrimental to market participants?
25. Are there any situations in which a product that has been mandated to trade exclusively on a DTF should be permitted to trade other than on a DTF? Should any category of market participants be exempt from a trading mandate?
26. Should there be a formal role for DTFs in initiating the process to specify that a class of OTC derivatives is mandated to trade exclusively on a DTF, comparable to the role of SEFs in the MAT process described on page 19?
27. What pre-trade transparency requirements are appropriate for OTC derivatives that have been mandated to be traded on a DTF? In particular, what precise pre-trade information should a DTF be required to publish for OTC derivatives that are subject to a DTF-trading mandate? Please be specific in terms of the execution method (e.g., order book, RFQ, etc.).
28. For the purpose of exempting large orders and quotes from pre-trade transparency requirements or permitting modified disclosure, how should an appropriate size threshold be determined?
29. Is it appropriate to limit trading in OTC derivatives that have been mandated to be traded on a DTF to specific permitted execution methods, e.g., an order book, or a request-for-quote system offered in conjunction with an order book? Why or why not? If so, which modes of execution should be permitted for products that are mandated to trade on a DTF? Can an appropriate level of pre-trade transparency be achieved with other methods of execution? What other factors should be considered?
30. What additional requirements should apply to DTFs with respect to trading in products that have been mandated to trade on a DTF?

### **General**

31. Please describe any specific characteristics of the Canadian OTC derivatives markets that the Committee should consider, which might justify a divergence between Canadian rules and those in effect in the US and the EU. Please consider transparency requirements, the trading mandate, and anything else you think relevant. Please refer to specific consequences of the characteristics you identify.

## COMMENTS AND SUBMISSIONS

The Committee invites participants to provide input on the issues outlined in this public consultation paper. You may provide written comments in hard copy or electronic form. The comment period expires March 30, 2015.

Certain CSA regulators require publication of the written comments received during the comment period. We will publish all responses received on the websites of the Autorité des marchés financiers ([lautorite.qc.ca](http://lautorite.qc.ca)), the Ontario Securities Commission ([osc.gov.on.ca](http://osc.gov.on.ca)), and the Alberta Securities Commission ([albertasecurities.com](http://albertasecurities.com)). Therefore, you should not include personal information directly in comments to be published. It is important that you state on whose behalf you are making the submission.

Please address your comments to each of the following:

Alberta Securities Commission  
Autorité des marchés financiers  
British Columbia Securities Commission  
Manitoba Securities Commission  
Financial and Consumer Services Commission (New Brunswick)  
Nova Scotia Securities Commission  
Ontario Securities Commission

Please send your comments only to the following addresses. Your comments will be forwarded to the remaining jurisdictions:

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## 1. INTRODUCTION

### (a) G20 commitment

At the G20 Summit held in Pittsburgh in September 2009, the leaders of the G20 countries agreed that:

All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest.<sup>11</sup>

The commitment to trade standardized OTC derivative contracts on exchanges or electronic platforms, where appropriate, is a central component of the G20 mandate to reform the OTC derivatives markets. A key objective of this mandate is to enhance the transparency and efficiency of OTC derivatives markets for the benefit of all market participants. Exchanges or electronic trading platforms can foster greater market integrity through transparent and enforceable participation and conduct requirements.<sup>12</sup>

### (b) Benefits of organized trading platforms

Organized trading platforms bring together many market participants where their trading interests can interact. The potential benefits of organized trading platforms have been described by international regulatory organizations to include the following:

- the use by participants of similar means to express trading interests and execute trades can result in the accumulation of pools of liquidity on trading platforms;
- the concentration of liquidity may foster broader market participation, resulting in greater operational efficiencies, increased competition and deeper markets;
- increased competition which may, in turn, put downward pressure on trading costs, including a reduction in bid/ask spreads;
- tight bid/ask spreads and deep liquidity particularly for benchmark derivatives contracts;<sup>13</sup>
- increased participation in the OTC derivatives market, contributing to making markets less susceptible to the impairment of a single liquidity provider;<sup>14</sup>

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<sup>11</sup> G20 Leaders Statement, at 9. Although the G20 commitment contemplates that mandatory trading should be in place by end of 2012, as stated by the Financial Stability Board (FSB) in April 2013, implementation is still progressing in FSB member jurisdictions after the end-of-2012 deadline: *OTC Derivatives Market Reforms: Fifth Progress Report on Implementation*, April 15, 2013 at 2. See also infra note 24.

<sup>12</sup> FSB, *OTC Derivatives Market Reforms: Sixth Progress Report on Implementation*, September 2, 2013 at 18.

<sup>13</sup> Committee of European Securities Regulators (CESR), *Standardisation and exchange trading of OTC derivatives*, 19 July 2010 (CESR/10-610) (CESR Report) at 18.

<sup>14</sup> IOSCO Trading Report at 38.

- greater market integrity through transparent and enforceable participation and conduct requirements;<sup>15</sup>
- the verification of trade information through electronic confirmations, and an efficient link to clearing agencies and trade repositories;<sup>16</sup>
- a higher level of transparency, and a reduction in information asymmetry;
- making price and other trade-related information directly available to the market thereby improving price discovery and pricing of assets and enhancing comparability and strengthening risk management;<sup>17</sup>
- allowing market participants to directly price derivatives, with the role of a platform operator being limited to bringing together or facilitating the bringing together of multiple third-party buying and selling interests; and
- improved transparency to and surveillance by regulators and likely a clearer trail in terms of positions and exposures.<sup>18</sup>

The extent to which these benefits would be realized will vary depending on the product or class of product being traded, as well as the particular characteristics of the platform, including, for example, the nature and degree of transparency, the level of discretion afforded a platform operator and the level of automation employed.

### **(c) Limitations to organized trading platforms**

The following limitations and potential drawbacks to the trading of OTC derivatives on organized platforms have also been identified:

- Platform trading may, depending on the structure of a platform, reduce the ability to customize contracts. This potential lack of flexibility may result in a lack of match with customers' needs, and a more limited possibility for product innovation.<sup>19</sup>
- The benefits of multilateral systems may appear only in some cases and not generally. As summarized by the CESR, "In this view, a multilateral system is not suitable for derivatives because of the bilateral character of contracts and little use of transparency information which disregard counterparty risk."<sup>20</sup>

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<sup>15</sup> Supra note 12.

<sup>16</sup> Council of Financial Regulators (Australia), *OTC Derivatives Market Reform Considerations*, March 2012 (**CFR Report**) at 4; IOSCO Trading Report at 37.

<sup>17</sup> Ibid. at 18.

<sup>18</sup> Ibid.

<sup>19</sup> CESR Report at 19. See also infra note 20 at 20.

<sup>20</sup> CESR, *Technical Advice to the European Commission in the Context of the MiFID Review- Standardisation and Organised Platform Trading of OTC Derivatives*, 21 December 2010 (CESR/10-1210) at 16.



- Mandating or forcing the trading of OTC derivatives on organized platforms could, if not done correctly, be damaging to product markets.<sup>21</sup>

Where a requirement to trade certain OTC derivatives on an organized trading platform introduces costs or risks that outweigh the benefits of trading in derivatives, participants may be discouraged from participating in the OTC derivatives market.

These limitations may be mitigated by requiring a minimum level of standardization and liquidity as a precondition to mandating that an OTC derivative, or class of OTC derivatives, trade through an organized trading platform. This would have a corollary result of excluding from any trading requirement bespoke or illiquid contracts, and potentially transactions above a certain size threshold (relative to the market for a specific type or class of OTC derivative).

**(d) Committee recommendations designed to encourage OTC derivatives to trade on organized trading platforms**

In Consultation Paper 91-401, the Committee outlined its proposals relating to the regulation of OTC derivatives in Canada. The following three options were proposed for purposes of addressing the G20 commitment on OTC derivatives trading:

- Option 1: Mandate trading of all OTC derivatives on organized trading platforms, with such a requirement being contingent on the availability of a platform that has been recognized or designated.
- Option 2: Mandate trading of only those transactions with sufficient standardization and liquidity and/or that pose systemic risks to the integrity of the markets.
- Option 3: Permit market participants to choose whether or not to trade on an organized trading platform.

The Committee stated that although the benefits of trading on an organized platform were considerable, much could be achieved through post-trade transparency, utilizing data gathered from trade reporting and mandated central clearing. The Committee noted that there are many valid reasons why OTC derivatives do not trade on exchanges, such as increased flexibility and the ability to hedge specific risks. In addition, due to the bespoke nature of many OTC derivatives products and the sheer number of their variations, it was unlikely that all OTC derivatives could be traded successfully on organized platforms. Nonetheless, the Committee felt that considerable benefits for both regulators and market participants resulting from increased transparency and liquidity could be achieved through the trading of certain OTC derivatives on organized platforms.<sup>22</sup>

The Committee now recommends that the CSA pursue Option 2 through the development of

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<sup>21</sup> CESR, *Technical Advice to the European Commission in the Context of the MiFID Review – Standardisation and Organised Platform Trading of OTC Derivatives*, October 2010 (CESR/10-1096) at 12.

<sup>22</sup> Consultation Paper 91-401 at 37-39.

- (1) a new regulatory category of “derivatives trading facility”, or DTF, for the trading of OTC derivatives, and
- (2) criteria for identifying appropriate OTC derivatives to be mandated to be traded exclusively through a DTF.

The Committee recommends that a DTF be permitted to offer trading in OTC derivatives that have not been mandated to trade on a DTF, though market participants would not be required to trade non-mandated derivatives through a DTF. Additional requirements would apply to a DTF in respect of trading in OTC derivatives that are subject to a DTF-trading mandate including, for example, with respect to pre-trade transparency.

This consultation paper sets out a proposed definition for a DTF as well as proposals regarding the characteristics of a DTF, including permitted execution methods, recognition or registration requirements, organizational and governance requirements, and pre- and post-trade transparency requirements. The paper concludes with a discussion of the proposed parameters of a trading mandate for sufficiently liquid and standardized OTC derivatives, and a brief discussion of the Committee’s recommended approach for the CSA with respect to organized derivatives trading platforms based outside of Canada.

The recommendations and proposals in this consultation paper relating to DTFs aim to create a system for regulating organized platform trading of OTC derivatives in Canada. The goal is to encourage the continued development of liquidity, transparency and standardization in the OTC derivatives market. In developing these regulatory proposals, we have been cognizant of the approaches taken in both the United States, with “swap execution facilities” (**SEFs**), and in the European Union, with “organized trading facilities” (**OTFs**).

## **2. OTHER JURISDICTIONS**

Recognizing the international character of OTC derivative markets, the Committee is of the view that a Canadian regulatory approach to the platform trading of OTC derivatives should have regard to the approach taken in other jurisdictions, particularly in the US and EU. Moreover, the Canadian regulatory approach should be designed to coordinate with international regulation where possible, while recognizing the relative size and liquidity of the Canadian market and the unique features of the Canadian regulatory framework.

The regulatory landscape relating to the use of organized trading platforms for OTC derivatives trading has changed significantly since the publication of Consultation Paper 91-401 in November 2010. Legislation in the US now requires all multilateral platforms trading swaps<sup>23</sup> to be registered as a SEF or a designated contract market (**DCM**) and factors have been established for determining those OTC derivatives that will be subject to mandatory trading on SEFs or DCMs. In the EU, a third category of regulated trading venue, OTF has been introduced alongside the existing categories of regulated market (**RM**) and multilateral trading facility

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<sup>23</sup> “Swap” is defined at 7 U.S.C. §1a(47). It is a complex definition that encompasses a broad variety of OTC derivatives contracts.

(MTF). Suitable OTC derivatives, e.g., those sufficiently liquid and standardized to be subject to a clearing requirement and also mandated to trade on a regulated trading venue, must be traded on one of the three venues.

Some jurisdictions have now implemented requirements that certain OTC derivatives be traded exclusively on organized trading platforms.<sup>24</sup> In the US, mandatory platform-trading has been implemented for certain types of interest rate and credit default swaps.<sup>25</sup> In the EU, a revised Markets in Financial Instruments Directive<sup>26</sup> (**MiFID II**), together with a Markets in Financial Instruments Regulation<sup>27</sup> (**MiFIR**), were adopted by the European Parliament and the Council of the European Union to facilitate, among other things, the mandatory trading of specified OTC derivatives. The texts of MiFID II and MiFIR came into force in the EU in July 2014, and must generally apply within European member states by January 3, 2017.

### (a) United States

In October 2013, the rules of the US Commodity Futures Trading Commission (the **CFTC**) for the mandatory trading of certain OTC derivatives on SEFs came into effect. A trading mandate is a key aspect of Title VII of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*<sup>28</sup> (the **Dodd-Frank Act**). The Dodd-Frank Act amended both the *Commodity Exchange Act*<sup>29</sup> and the *Securities Exchange Act of 1934* to establish a comprehensive new regulatory framework for swaps and security-based swaps in the wake of the financial crisis.

The Dodd-Frank Act provides that, where a derivative is subject to the clearing requirement (meaning it must be centrally cleared unless an exemption is available), and any SEF or DCM (i.e., a registered futures exchange) “makes” the derivative “available to trade” (i.e., it is subject to a **MAT determination**), then it must be traded on a SEF or a DCM.

The CFTC established in June 2013 a flexible process for SEFs to make a derivative “available to trade”. SEFs are to determine which derivatives they wish to make available to be traded on their platforms. The MAT determination is then submitted to the CFTC either as self-certified by the trading platform or for CFTC approval. Unless the filing is found to be contrary to the CFTC’s regulations, the derivative, if subject to the clearing requirement, will become subject to

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<sup>24</sup> The FSB reported that, as at November 2014, three jurisdictions – China, Indonesia and the US – had regulations in effect requiring organized platform trading. In 2015 such regulations are also expected to become effective or partially effective in India, Japan, and Mexico: FSB, *OTC Derivatives Market Reforms: Eighth Progress Report on Implementation*, November 7, 2014 at 24.

<sup>25</sup> In the US, the requirement to execute certain interest rate and credit default swaps on “swap execution facilities”, foreign boards of trade or designated contract markets took effect in mid-February 2014; see <http://sirt.cftc.gov/sirt/sirt.aspx?Topic=SwapsMadeAvailableToTradeDetermination>.

<sup>26</sup> Directive no. 2014/65/EU of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (recast) (**MiFID II**): [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:JOL\\_2014\\_173\\_R\\_0009](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:JOL_2014_173_R_0009).

<sup>27</sup> Regulation no. 600/2014 of the European Parliament and of the Council on markets in financial instruments and amending Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (**MiFIR**): [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.173.01.0084.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.173.01.0084.01.ENG).

<sup>28</sup> [http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/hr4173\\_enrolledbill.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/hr4173_enrolledbill.pdf).

<sup>29</sup> Codified as Title 7 of the United States Code: <http://www.law.cornell.edu/uscode/text/7/chapter-1>. As section numbers do not always align, note that references herein are to the U.S. Code, not to the Commodity Exchange Act.

a trading mandate. Since January 2014, the CFTC has approved or deemed certified as available to trade certain specified interest rate swap (**IRS**) and credit default swap (**CDS**) contracts pursuant to MAT determinations by five different SEFs. Once the MAT determinations became effective the specified CDS and IRS contracts became subject to what is known as the “trade execution requirement”.<sup>30</sup> A transaction in a swap that is the subject of a certified MAT determination may be made on any SEF or DCM, not just the SEF that submitted the MAT determination.

A SEF is defined under the Dodd-Frank Act to mean “a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system”, and that is not a DCM.<sup>31</sup>

All registered SEFs must offer a “minimum trading functionality” for transactions in all derivatives listed on the SEF, consisting of an order book, or an RFQ system offered in conjunction with an order book. For purposes of the SEF rules, an order book is defined as an “electronic trading facility”,<sup>32</sup> a “trading facility”,<sup>33</sup> or a trading system or platform in which all market participants have the ability to enter multiple bids and offers, observe or receive bids and offers, and transact on such bids and offers.

The rules do not impose any specific algorithm for matching participant bids and offers on an order book.<sup>34</sup>

One-on-one voice and single-dealer platforms do not meet the definition of a SEF, and may not trade derivatives that are subject to the trade execution requirement because they do not provide for the multiple-to-multiple interaction of buying and selling interests.

A SEF may provide RFQ functionality for those market participants that do not wish to display their bids, offers, or requests to all other market participants. An RFQ functionality allows a participant to transmit a request for a quote to a minimum number<sup>35</sup> of market participants in the trading system or platform, to which such market participants may respond.<sup>36</sup> A SEF’s RFQ system may include a voice component.

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<sup>30</sup> I.e., mandatory trading on either a DCM or a SEF; see Title 17 Chapter I of the Code of Federal Regulations, [http://www.ecfr.gov/cgi-bin/text-idx?SID=2ed6cb4f87f8320c844139f05049281d&tpl=/ecfrbrowse/Title17/17tab\\_02.tpl](http://www.ecfr.gov/cgi-bin/text-idx?SID=2ed6cb4f87f8320c844139f05049281d&tpl=/ecfrbrowse/Title17/17tab_02.tpl) (CFTC Regulations), §37.9(a) and 7 U.S.C. §2(h)(8).

<sup>31</sup> Dodd-Frank Act, s. 2(6); 7 U.S.C. §1(a)(50).

<sup>32</sup> 7 U.S.C. §1a(16) defines electronic trading facility as “a trading facility that—  
(A) operates by means of an electronic or telecommunications network; and  
(B) maintains an automated audit trail of bids, offers, and the matching of orders or the execution of transactions on the facility.”

<sup>33</sup> 7 U.S.C. §1a(51) defines trading facility in paragraph (A) as “a person or group of persons that constitutes, maintains, or provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts, or transactions—  
(i) by accepting bids or offers made by other participants that are open to multiple participants in the facility or system; or  
(ii) through the interaction of multiple bids or multiple offers within a system with a pre-determined non-discretionary automated trade matching and execution algorithm.”

<sup>34</sup> CFTC Regulations §37.3.

<sup>35</sup> For products not mandated to trade on a DCM or a SEF (i.e., for “permitted transactions”), the RFQ need not be sent to a minimum number of participants.

<sup>36</sup> CFTC Regulations at s. 37.9(a)(3).

In order to provide RFQ functionality for trading in products subject to a MAT determination, a SEF's RFQ system must be able to satisfy all of the following minimum functional requirements:

- (1) receive a request for quotation from a market participant;
- (2) submit that request to at least the prescribed minimum number<sup>37</sup> of unaffiliated market participants chosen by the requester;
- (3) communicate the RFQ responses and any firm resting bids or offers on the order book to the RFQ requester; and
- (4) allow the requester to execute against such firm resting bids or offers along with any responsive orders (RFQ responses).

The regulations do not require a SEF to display a requester's RFQ to market participants not participating in the RFQ. SEFs are also not required to display responses to an RFQ to anyone but the RFQ requester.<sup>38</sup> At the same time that the RFQ requester receives the first responsive bid or offer, the SEF must communicate to the requester any firm bid or offer pertaining to the same instrument resting on the SEF's order book(s).<sup>39</sup>

In providing either order book or RFQ functionality, a SEF may, for purposes of execution and communication, use "any means of interstate commerce, including, but not limited to, the mail, internet, email, and telephone", provided that the execution method otherwise satisfies the minimum requirements under CFTC regulations applicable to order book and RFQ functionality for SEFs.<sup>40</sup>

## **(b) European Union**

MiFID II and MiFIR introduce new rules with respect to trading infrastructure. Among other things, they introduce the new trading venue category of OTF. Alongside RMs and MTFs, OTFs will be a third type of multilateral system in which multiple buying and selling interests can interact in a way that results in contracts. However, unlike RMs and MTFs, an OTF will only be permitted to trade derivatives and certain non-equity instruments, namely bonds, structured finance products and emissions allowances.<sup>41</sup> Operating an OTF will be considered to be providing an investment service so a person wishing to do so will need to be licensed as an investment firm. An RM operator will also be permitted to operate an OTF. Under MiFID II, the main factor distinguishing an OTF from an RM or MTF is that the operator of an OTF would have discretion over how a transaction is to be executed, whereas the interaction of orders on an RM or MTF must be non-discretionary.

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<sup>37</sup> At least two unaffiliated market participants the first year after the final rule, and at least three unaffiliated market participants thereafter.

<sup>38</sup> CFTC Regulations at s. 37.9(a)(3).

<sup>39</sup> Ibid. at 37.9(3)(i).

<sup>40</sup> Ibid. at s. 37.9(a)(2)(ii).

<sup>41</sup> MiFIR at preamble (8).

The operator of an OTF would be permitted to exercise its discretion in two circumstances: (i) when deciding to place an order on the OTF or to retract it; and (ii) when deciding not to match a specific order with the orders available in the system at a given point in time, provided that this complies with specific instructions received from clients and with best execution obligations.

The operator of an OTF will be able to decide when and how to match a client order, and therefore to facilitate negotiation between clients, so as to bring together two or more potentially compatible trading interests. As a result of this discretion, the operator of an OTF will owe investor protection duties to its clients, consisting of conduct of business rules, best execution, acting in accordance with the client's best interest and client order handling obligations.<sup>42</sup>

Like RMs and MTFs, OTFs will be required to have transparent and non-discriminatory rules governing access to the facility. Unlike RMs and MTFs, OTFs will be permitted to determine and restrict access to their platforms based, among other things, on the role and obligations which the operator of an OTF will have in relation to its clients.<sup>43</sup>

The concept of an OTF does not include a facility “where there is no genuine trade execution or arranging taking place in the system, such as bulletin boards used for advertising buying and selling interests, other entities aggregating or pooling potential buying or selling interests, electronic post-trade confirmation services, or portfolio compression, which reduces non-market risks in existing derivatives portfolios without changing the market risk of the portfolios.”<sup>44</sup>

The OTF category was intended to include much of the inter-dealer market. Subject to limited exceptions with respect to sovereign debt, an investment firm or market operator operating an OTF will be prohibited from executing client orders on the OTF against its own proprietary capital or that of any entity that is part of the same “group or legal person” as the operator.<sup>45</sup> Unlike the operator of an RM or MTF, the operator of an OTF will be permitted, with client consent, to engage in matched principal trading<sup>46</sup> of OTC derivatives that are not subject to a trading obligation. When matched principal trading is used, the OTF must comply with all pre-trade and post-trade transparency requirements and best execution obligations. An OTF operator or any entity that is part of the same group or legal person as the investment firm or market operator should not act as systematic internaliser<sup>47</sup> in the OTF it operates. The OTF operator should also be subject to the same obligations as an MTF in relation to potential conflicts of interest.<sup>48</sup>

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<sup>42</sup> MiFIR, preamble (9).

<sup>43</sup> MiFID II, preamble (14).

<sup>44</sup> MiFIR, preamble (8).

<sup>45</sup> MiFID II, Article 20 at s. 1.

<sup>46</sup> MiFID II, Article 4(1)(38) defines matched principal trading as “a transaction where the facilitator interposes itself between the buyer and the seller to the transaction in such a way that it is never exposed to market risk throughout the execution of the transaction, with both sides executed simultaneously, and where the transaction is concluded at a price where the facilitator makes no profit or loss, other than a previously disclosed commission, fee or charge for the transaction”.

<sup>47</sup> A systematic internaliser has been defined as an investment firm ‘which on an organised, frequent and systematic’ basis deals on own account by executing client orders outside a regulated market or MTF: European Securities and Markets Authority (ESMA), *Discussion Paper: MiFID II/MiFIR, (ESMA Discussion Paper)*, May 22, 2014 at s. 3.3.

<sup>48</sup> MiFIR, preamble (10).

In order to implement the G20 commitment to require standardized derivatives to be traded on exchanges and electronic platforms, MiFIR also creates a platform-trading obligation such that certain derivatives can only be traded on an RM, MTF, OTF or an equivalent third-country trading venue.<sup>49</sup> MiFIR sets out a procedure for determining whether a derivative should be subject to the platform-trading obligation. In implementing this procedure, ESMA will develop technical standards declaring which classes (or sub-classes) of OTC derivatives should be required to be traded only on these specified platforms.

Generally speaking, to be subject to the platform-trading obligation, a class of OTC derivative would be determined to be subject to the clearing obligation, traded on at least one RM, MTF or OTF, and considered sufficiently liquid.<sup>50</sup> The MiFIR contemplates that liquidity would be considered to exist when there are “ready and willing buyers and sellers on a continuous basis”. Having regard to the trading venue and the particular class of OTC derivative, the assessment would involve consideration of the average frequency and size of trades in the class of derivatives over a range of market conditions; the nature and lifecycle of products within the class of derivatives; the number and type of active market participants including the ratio of market participants to products or contracts traded in a given market; and the average size of the bid/ask spreads.<sup>51</sup>

In preparing draft technical standards, ESMA is required to take into consideration the anticipated impact that a trading obligation might have on the liquidity of a class of derivatives or a relevant subset thereof and the commercial activities of end users which are not financial entities.<sup>52</sup>

### **3. MARKETPLACES REGULATED UNDER NI 21-101 AND NI 23-101**

NI 21-101 provides a regulatory framework to regulate the operation of “marketplaces”; NI 23-101 governs trading on marketplaces. NI 21-101 uses the term “marketplace” to describe a facility or venue on which securities – and, in some CSA jurisdictions, derivatives – can be traded, including exchanges, quotation and trade reporting systems (**QTRSs**), alternative trading systems (**ATSs**) and other types of trading systems. In general, each of these marketplaces share the following characteristics:

- (a) they constitute, maintain or provide a market or facility for bringing together buyers and sellers,

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<sup>49</sup> MiFIR, Article 28 at s. 1.

<sup>50</sup> FIA/FIA Europe, Special Report Series: Market Infrastructure Under MiFID II, 13 June 2014.

<sup>51</sup> MiFIR, Article 2(1)(17) and ESMA Discussion Paper at s. 3.6.

<sup>52</sup> MiFIR, Article 32 at s. 3.

- (b) they bring together orders of multiple buyers and sellers, and
- (c) they use established, non-discretionary methods under which the orders interact with each other, and the buyers and sellers entering the orders agree to the terms of a trade.<sup>53</sup>

NI 21-101 and NI 23-101 do not provide that the operator of a marketplace regulated thereunder may exercise discretion in the execution of trades on the marketplace. In contrast, customary execution methods in respect of OTC derivative instruments may involve the exercise of discretion in the execution of transactions, as described below. Furthermore, trades executed on a marketplace regulated under NI 21-101 must be reported to and settled through a clearing agency, whereas the OTC derivatives markets that are the subject of this paper do not necessarily impose such an obligation, and it is proposed that trades executed through a DTF would not be required to be cleared unless the derivative were of a class that had been mandated to be cleared pursuant to a clearing rule.

In the Committee's view, the OTC derivatives market in Canada could benefit from a regulatory framework that has sufficient flexibility to accommodate the unique features of OTC derivatives trading, including discretionary execution methods.

The Committee recommends that rules be developed to introduce the DTF as a new category of trading venue, specifically intended for OTC derivatives. We propose that DTFs be subject to rules tailored specifically to the organized platform trading of OTC derivatives, and which are separate from NI 21-101 and NI 23-101. To the extent appropriate, rules governing DTFs would be consistent with comparable requirements in NI 21-101 and NI 23-101.

#### **4. DEFINING "DERIVATIVES TRADING FACILITY"**

Having considered the regulatory context related to OTC derivatives trading platforms in the United States and Europe and the existing regulatory framework for marketplaces in Canada, we set out below the Committee's recommendation for the regulation of OTC derivatives trading facilities in Canada.

##### **(a) Scope and key characteristics**

The key characteristics of an organized trading platform that would constitute a DTF are described below.

##### **(i) Execution**

The Committee recommends that the application of the proposed DTF regulatory regime be limited to those systems and/or facilities that bring together multiple buying and selling interests leading to the execution of OTC derivatives transactions. This would not include bulletin boards and similar facilities that do not provide for the execution of transactions.

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<sup>53</sup> Except in Ontario, the term "marketplace" is defined in subsection 1.1(a) of NI 21-101. In Ontario, the term is defined under subsection 1(1) of the *Securities Act* (Ontario).



**(ii) Single dealer vs. Multi-dealer**

The Committee recommends that the DTF regulatory regime be aimed at regulating those platforms that are multi-dealer or that facilitate many-to-many transactions. At this time we do not propose that single-dealer or one-to-many platforms be governed under this regime.

We note that platforms that trade OTC derivatives generally fall into one of two broad categories: those with a single liquidity provider (single-dealer/one-to-many platforms) and those with multiple liquidity providers (multi-dealer platforms). One-to-many platforms are structured around a single liquidity provider that provides liquidity for all trades on a bilateral basis to one or more counterparties. Broadly speaking, one-to-many platforms resemble the direct, principal-to-principal bilateral negotiation of transactions, traditionally by telephone, which has historically been the dominant mode of transacting in OTC derivatives. In contrast, multi-dealer platforms are multilateral (i.e., multiple-to-multiple) platforms structured to facilitate the interaction of multiple buying and selling interests, as well as competitive execution systems involving firm bids and offers from multiple dealers. Examples of multi-dealer platforms include (i) an RFQ system, where a participant requests a quote from multiple dealers that have been selected by the participant, and (ii) a competitive interaction of firm bids and offers through, for instance, an order book.<sup>54</sup>

**(iii) Discretionary execution and order books**

Derivatives trading platforms can also be distinguished by the degree of discretion, if any, that the operator of a platform is permitted to exercise over the execution process. In this context, discretion describes the ability of the platform operator to determine independently, among other things, when to place an order for a participant or to retract it; which participants are contacted with client RFQs; which client orders or RFQs are matched with other orders or quotes; the order and timing of such matching; and how the trade is executed (e.g., by way of voice, RFQ or another execution method). Such discretion assists the facility in seeking liquidity and arranging and negotiating transactions between buying and selling interests prior to execution.<sup>55</sup> Trading itself may then be neither continuous nor fully electronic, which can be important for purposes of finding liquidity in products that tend to trade episodically.

In contrast, some platforms, such as those utilizing an order book, are non-discretionary. A transparent order book in its most basic form allows market participants to enter multiple bids and offers, observe bids and offers entered by other market participants, and choose to transact on such bids and offers.<sup>56</sup> Such systems typically incorporate pre-determined criteria governing the prioritization of and interactions between orders, so as to provide a transparent and objective basis for the continuous or periodic execution of transactions. The operator provides the same prices for the same volume of trading interest in the same market situation, irrespective of the

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<sup>54</sup> IOSCO Trading Report at 30.

<sup>55</sup> As discussed below, discretion exercised solely by the participants themselves is not what is meant here. What is referred to here is the situation where a party plays an active role in brokering the deal between the two participants, such as the role typically played by an interdealer broker in contacting potential counterparties and negotiating price and volume on behalf of (a typically undisclosed) client.

<sup>56</sup> Supra note 54 at 10.

individual participant or client.<sup>57</sup> The operator is in effect left out of the execution process with no discretion as to how interests may interact.<sup>58</sup>

It is important to distinguish between the discretion that a platform operator may have in executing transactions from the discretion that participants may have. We would not consider a DTF to be providing discretionary execution merely because its participants have the ability to amend or cancel their orders or to choose their counterparties under the rules of the platform. Similarly, we would not consider actions taken by a platform operator to ensure market integrity, such as cancelling or amending erroneous or unreasonable trades according to its rules,<sup>59</sup> or blocking access to the platform by a “runaway” algorithm, as an exercise of discretionary execution by a DTF.

We would also not consider a DTF to be exercising discretion only by reason of the communications medium involved (e.g., voice calls). For example, a non-discretionary trading system may feature a voice-order taker employed by the DTF, who receives telephone calls and enters orders into an order book or sends out an RFQ to specific participants as instructed by the caller.<sup>60</sup>

At this time, we have not defined a DTF to exclude platforms or facilities that engage in discretionary trading methods. This approach is consistent with the regulatory objective of regulating all multilateral facilities for trading in OTC derivatives. The Committee is considering whether to recommend allowing a DTF operator to exercise discretion for trading in some OTC derivatives. If the Committee does recommend allowing discretion, in order to address issues such as conflicts of interest we contemplate that DTFs that employ discretionary trading methods would be subject to additional requirements similar to those that apply to a dealer. Requirements currently under consideration by the Committee include requirements to act in the best interests of a client, including best execution obligations.<sup>61</sup> Furthermore, if the Committee does recommend allowing discretion, it may nevertheless recommend that discretion not be permitted in the execution of trades in products that have been mandated to be traded on a DTF.

## **(b) Proposed Definition of a DTF**

### **(i) OTC Derivatives**

OTC derivative is used in this paper in its customary sense to refer to a derivatives contract that is traded other than on a formal exchange, such as on a dealer network or directly between two parties. However, for the purposes of this paper, an OTC derivative does not cease to be an OTC derivative merely because it may be traded on an exchange. This is important because, as

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<sup>57</sup> Committee of European Securities Regulators (CESR), CESR Technical Advice to the European Commission in the Context of the MiFID Review – Equity Markets (CESR/10-802), 29 July 2010 (**CESR Technical Advice**) at 19.

<sup>58</sup> MiFIR at recital (7).

<sup>59</sup> Subject to appropriate conflict-of-interest rules and oversight.

<sup>60</sup> However, if that employee were to engage in negotiations with one or more other market participants on behalf of the market participant who placed the order, this would be indicative of a discretionary trading arrangement.

<sup>61</sup> This is discussed in more detail below in section 6, Regulatory Authorization of DTFs.

discussed elsewhere, the Committee anticipates that in some jurisdictions a DTF may be recognized as an exchange.

**(ii) DTF**

The Committee proposes to define a DTF to mean a person or company that constitutes, maintains, or provides a facility or market that brings together buyers and sellers of OTC derivatives, brings together the orders of multiple buyers and multiple sellers, and uses methods under which the orders interact with each other and the buyers and sellers agree to the terms of trades.

The proposed definition of a DTF is intentionally broad and would capture various multilateral execution processes and venues. However, the proposed definition is not intended to capture purely bilateral trading, nor one-to-many facilities such as single-dealer platforms. A participant providing trading services to its clients via a single-dealer platform would instead be subject to dealer registration requirements.

Similarly, the proposed definition would not capture facilities or processes where there is no actual trade execution or arranging taking place, such as bulletin boards used for advertising buying and selling interests, other entities aggregating or pooling potential buying or selling interests, electronic post-trade confirmation services, or portfolio compression, which reduces non-market risks in existing derivatives portfolios without changing the market risk of the portfolios.

As discussed above, the Committee is considering whether to recommend allowing discretionary trade execution methods for some trading on DTFs, and the proposed DTF definition is intended to be broad enough to encompass facilities employing such methods. Should the exercise of discretion ultimately be permitted, we anticipate that a DTF that offered such discretionary execution methods would be permitted do so as part of the same entity offering other execution methods, subject to the entity complying with appropriate conflict-of-interest rules.

It is the Committee's intention that the existing framework for the regulation of securities and futures exchanges, ATS's and QTRS's would not be impacted by the new DTF category. The Committee recommends that exchanges trading derivatives that are not OTC derivatives not be regulated as DTFs in respect of their existing or future non-OTC derivatives operations. Existing exchanges that wished to provide a platform for trading in OTC derivatives would be required to apply for authorization to offer trading in OTC derivatives.

The Committee acknowledges that some trading platforms may operate as *both* marketplaces<sup>62</sup> under NI 21-101 and DTFs under applicable securities legislation (for instance, a platform that is both an ATS and a DTF). This may occur, for example, where an existing marketplace begins to offer trading in OTC derivatives. The Committee recommends that such hybrid marketplace-DTFs be subject to different regulatory regimes with respect to the different types of products for which they offer trading. The regulation of hybrid marketplace-DTF platforms would be

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<sup>62</sup> Including exchanges.

addressed by CSA members on a case-by-case basis, with a view to mitigating or eliminating duplicative regulation.

**Question 1:** *Is the DTF category appropriately defined? If not, what changes are needed and why?*

**Question 2:** *Is it appropriate to permit DTF operators a degree of discretion over the execution of transactions? Why or why not? If discretion is permitted, should it be permitted only for trading in products that have not been mandated to trade on a DTF?*

## 5. PERMITTED EXECUTION METHODS

The Committee recommends that a DTF be permitted to use a range of multiple-to-multiple trading functionalities. Some examples of execution methods a DTF might use include the following:

- **order book** systems, typically fully automated, in which market participants can enter multiple bids and offers, observe bids and offers entered by other market participants, and choose to transact on such bids and offers. Order book systems can operate either continuously, or periodically based on the execution of orders in batches at set intervals, and may execute trades automatically at prices determined by a prescribed methodology;
- **RFQ** systems in which participants could transmit a request for a quote on an OTC derivative to market makers in the trading system or platform, to which such market participants may respond;
- **request-for-stream** systems, whereby market makers provide continuous streaming *firm* quotes to buy and sell derivatives contracts for a predefined period of time based upon a client's interest. The client receiving such streaming quotes can "click-to-trade" when the client is prepared to execute the transaction; or
- **hybrid** systems that blend execution functionalities, including those described above (for instance, an RFQ system linked to an order book as described below), or that combine an electronic platform with an element of voice negotiation in the execution of the transaction.<sup>63</sup>

These are merely examples, and the Committee expects that CSA members, upon appropriate review, could find other execution methods also acceptable.

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<sup>63</sup> To illustrate, some multilateral systems provide for matching of indicative quotes. However, once matching interests are identified, a broker (the operator) directs negotiation of the final terms between the parties, discretionarily asking the parties to offer specific terms and thus shaping the deal. This is a common situation with many complex derivatives and fixed income products, though it is expected that technological progress will continue to reduce the need for such operator intervention: European Capital Markets Institute, *Setting the Institutional and Regulatory Framework for Trading Platforms: Does the MiFID definition of OTF make sense?*, by Diego Valiante, ECMI Research Report No. 8, April 2012 at 5–6.

As noted above, the Committee recommends that a DTF be permitted to use a hybrid system that blends execution functionalities. In particular, the Committee contemplates that a DTF might use an RFQ system that is linked to an order book in a manner similar to the requirements applicable to a SEF in the United States (described on page 21). Like on a SEF, the Committee contemplates that transactions could be executed exclusively through the RFQ system (i.e., off-order book) on the basis that pre-trade transparency would be provided by virtue of the RFQ functionality and the existence of the associated order book upon which the mandated product trades.

The Committee recommends that permitted execution methods include both systems that do and those that do not disclose counterparty identities. For instance, order book systems operating in some jurisdictions may not disclose the identity of the counterparties, while in a hybrid system participants often do not know who the other counterparty is until the negotiation of a transaction has been concluded. With RFQ systems, trading interest is initiated by a client requesting firm quotes from market makers. In some cases, the identities of both counterparties may be fully disclosed to each other in advance of execution.<sup>64</sup> Other RFQ systems may involve dealers and clients having pre-arranged credit limits which the system enforces, preserving the anonymity of both the requesting participants and the dealers who provide quotes.

As discussed above, the Committee is contemplating whether, and the extent to which, the operator of a DTF should be permitted to exercise discretion in the execution of trades. If discretion is permitted, the Committee may recommend that it be permitted only for products that are not mandated to be traded exclusively on a DTF.

***Question 3: Is the description of permitted execution methods for a DTF suitable for facilities that currently offer or plan to offer trading in OTC derivatives?***

***Question 4: Please comment on required modes of execution. Should any particular minimum trading functionality be prescribed for DTFs generally?***<sup>65</sup>

## **6. REGULATORY AUTHORIZATION OF DTFs**

The Committee recommends that a DTF, regardless of whether or not it offers trading in OTC derivatives that are mandated to trade exclusively on a DTF, will require an authorization from the securities regulatory authority in each jurisdiction in which it operates, or an exemption from such requirement. The Committee recommends that DTFs generally be regulated similarly to exchanges. Additionally, a DTF that exercises discretion in the execution of transactions would be subject to requirements that are similar to those applicable to derivatives dealers.

It is the Committee's intention that the features and requirements of DTFs be harmonized across the various jurisdictions in Canada. However, in some provinces a DTF may be a category of exchange, while in other provinces a DTF may be a new type of entity. In either case, as

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<sup>64</sup> Technical Committee of the International Organization of Securities Commissions (IOSCO), *Follow-On Analysis to the Report on Trading of OTC Derivatives*, January 2012 at 11-12.

<sup>65</sup> As contrasted with those execution methods that would be permitted for products that are mandated to trade on a DTF; see Question 29.

discussed above, NI 21-101 would not apply to DTFs, and a new regulatory framework, with such similarities to NI 21-101 as are appropriate, would apply.

**(a) Base regulation for all DTFs**

The Committee recommends that a basic level of regulation apply to all DTFs (i.e., the base level of regulation would apply to a DTF that employed only non-discretionary methods of execution, such as an order book or an RFQ system following set rules regarding routing of requests and quotes).

The Committee recommends that all DTFs be required to perform an appropriate regulatory function by, among other things, having established requirements to govern the conduct of participants on the DTF and, whether directly or indirectly through an authorized regulation services provider, monitoring compliance by participants with those requirements and appropriately disciplining participants in the event of non-compliance. The DTF's rules would be required to be designed to ensure compliance with applicable securities legislation, prevention of fraud and manipulative acts and practices, and the promotion of just and equitable principles of trade. A DTF would only be responsible to regulate activity taking place on that DTF. A DTF may also be subject to requirements relating to internal controls and systems, and such other requirements that currently apply to marketplaces as may be appropriate.

**(b) DTFs exercising discretion**

Additionally, the Committee recommends that a DTF that exercises discretion in the execution of transactions (as discussed above) be subject to requirements that are similar to those applicable to derivatives dealers.<sup>66</sup> Such a DTF would be required to retain a third-party regulation services provider to perform its regulatory function, including monitoring and enforcing the conduct of participants on the DTF—including the DTF operator itself—in light of the fact that the operator would be acting as a dealer on its own platform. Appropriate requirements addressing conflicts of interest would also apply.

The Committee recommends that a DTF exercising discretion be required to comply with relevant dealer requirements including, for example, a duty to act fairly, honestly and in good faith, proficiency requirements for individual representatives of the DTF, “know your client” and suitability obligations, account handling requirements, confidentiality of customer information, and best execution.<sup>67</sup> A DTF exercising discretion would also need to first inform its participants of the extent of its discretion and obtain consent from each participant of the DTF with respect to exercising discretion in its trading interactions with the participant.

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<sup>66</sup> See CSA Consultation Paper 91-407 – *Derivatives: Registration*, published on April 18, 2013.

<sup>67</sup> NI 23-101 and its Companion Policy set out best execution obligations in the context of securities trading. Similar considerations may apply to trading on DTFs, as well as additional factors that may be relevant specifically to derivatives trading.

**Question 5:** *Is the proposed regulatory framework for DTFs appropriate?*

**Question 6:** *Is it appropriate to impose dealer requirements on a DTF where the operator of the DTF exercises discretion in the execution of transactions? (Please explain.) If so, should such a DTF be required to register as a dealer, or should only certain dealer requirements be imposed on the DTF? (Which ones?)*

**Question 7:** *To address conflicts of interest, should a DTF that exercises discretion in the execution of transactions be required to exercise this functionality in a separate affiliated entity? Why or why not?*

**Question 8:** *What factors are relevant in defining the proposed best execution duty?*

## **7. ORGANIZATIONAL AND GOVERNANCE REQUIREMENTS**

All DTFs would be required to meet a number of basic organizational and governance requirements, including with respect to financial resources, systems, personnel, rules, monitoring, record-keeping, conflicts of interest and, where appropriate, non-discriminatory access.

Comparable to those established in NI 21-101 and NI 23-101, these requirements would include policies and procedures and, where applicable, agreements between participants and the facility, designed to define access requirements, ensure best execution,<sup>68</sup> ensure the integrity of market quotations and prices, clearly establish the characteristics of derivatives traded on the DTF, and require the implementation of compliance systems and oversight processes. A summary of the requirements recommended by the Committee is set out below.

### **(a) Access**

To ensure that the rules, policies, procedures, and fees, as applicable, of a DTF do not unreasonably create barriers to access to the services provided by the DTF:

- a DTF would be required to establish written standards that are transparent and equitable for granting access to each of its services, including trade feeds to regulated clearing agencies, and keep records of (i) each grant of access, including the reasons for granting access to an applicant, and (ii) each denial or limitation of access, including the reasons for denying or limiting access to an applicant; and
- a DTF would be prohibited from unreasonably prohibiting, conditioning, or limiting access by a person or company to services offered by the DTF.

A DTF would be required to set fees that were fair and transparent, did not create unreasonable barriers to access and were commensurate with the services provided.

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<sup>68</sup> Supra note 67.

The operator of a DTF might wish to require that all trades on its facility be cleared. The Committee is considering whether it is appropriate to allow a DTF to set such a requirement. (The Committee recognizes that a DTF may offer trading in products that are not cleared at all. Therefore such a requirement, if permitted, would apply only to trades that are capable of being cleared.)

Similarly, the Committee is considering whether or not it would be appropriate to allow a DTF to tie the use of its facility to a specified clearing agency or trade repository, having regard to the number of clearing agencies and trade repositories anticipated to be operating in Canada.<sup>69</sup> Prohibiting such tying could enhance market participants' choice in market infrastructure providers; however, it could also reduce the efficiency of clearing and transaction reporting, and it may be an unreasonable burden to require a DTF to establish links with all recognized trade repositories and clearing agencies.

Finally, the Committee is considering whether to permit a DTF that exercises discretion in trade execution to determine and restrict access to its services based on the role and obligations that the operator will have in relation to its participants.<sup>70</sup> Possible grounds for limiting access might include factors related to client sophistication and technical capability. To prohibit a DTF that exercises execution discretion from restricting access to its services could, in the Committee's view, result in the operator of a DTF being forced to assume a dealer-client relationship in respect of a particular person or company even where deemed unsuitable by the DTF operator.

***Question 9: Is it appropriate to allow a DTF to require clearing of all trades on the DTF that are capable of being cleared?***

***Question 10: Is it appropriate to allow a DTF to require transactions executed on its facility to be cleared through a particular clearing agency and/or reported to a particular trade repository?***

***Question 11: Is it appropriate for a DTF that exercises discretion in trade execution to be permitted to limit access to its facility? If so, on what grounds should it be permissible?***

## **(b) Regulatory function and market surveillance**

DTFs would be required to establish requirements to govern the conduct of their participants on the platform, and to monitor and enforce compliance with these requirements.

All DTFs would be subject to a requirement to take all reasonable steps to ensure that its operations do not interfere with fair and orderly markets. This obligation would apply both to the operation of the DTF itself and to the impact of the DTF's operations on the Canadian market as a whole.<sup>71</sup>

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<sup>69</sup> Comparable to NI 21-101, s. 5.1 and proposed s. 13.2 published on April 24, 2014.

<sup>70</sup> This is comparable to the requirement in MiFID II that "OTFs should be able to determine and restrict access based inter alia on the role and obligations which they have in relation their clients": MiFID II, preamble (14).

<sup>71</sup> Comparable to s. 5.7 of NI 21-101.



**(i) DTFs generally**

All DTFs would be expected to perform certain regulatory and surveillance functions. The Committee contemplates that a DTF that does not exercise execution discretion may perform its regulatory and surveillance functions either itself or through a regulation services provider. A DTF that does exercise discretion would be required to retain an authorized third-party regulation services provider to monitor and enforce compliance with the rules of the DTF. The Committee contemplates that these regulatory and surveillance functions would include, but may not be limited to, the following:

- personnel and system capability for real-time monitoring of all activities in the entire transaction cycle on the trading platform;
- reporting of any improper, disorderly or disruptive trading activity on its facilities, including potential manipulative or abusive transactions or behaviour, to regulators;
- systems capable of sharing information related to activities of the entire transaction cycle with regulators on real-time basis; and
- systems capable of recreating the trading environment at any point during the last seven years within a reasonable period of time.

The Committee contemplates that DTFs would be required to enforce compliance with their rules by means other than merely exclusion from the DTF (e.g., by fines). DTFs would be required to maintain sufficient resources to discipline, suspend, or expel participants that violate its rules, and to establish and impartially enforce rules governing denials, suspensions, and revocation of a participant's access privileges to the DTF.

**(ii) DTFs with discretion**

DTFs exercising discretion in the trade execution process would be required to retain a third-party regulation service provider to perform the functions described above, since compliance by both the participants and the operator itself—due to its dealer-like functions—would need to be monitored.

**(c) Rules**

A DTF would be required to establish and clearly define rules governing the operation of the DTF and the conduct of the participants on the platform, and to make such rules publicly available. Rules would be required to address:

- participant conduct for order entry and trade executions to address abusive trading practices and/or manipulations;
- emergency procedures for matters such as trading halts or disruptions;

- procedures to resolve any disputes relating to trading activity on the platform, including disputes resulting from decisions, rulings or other determinations made by platform staff; and
- if applicable, the DTF's trading protocol, including the order entry mechanism and priority sequence of any transaction matching.

DTFs would also be required to have rules and policies that are not contrary to the public interest and are designed to

- require compliance with securities legislation;
- ensure compliance with applicable legislation;
- prevent fraudulent and manipulative acts and practices;
- promote just and equitable principles of trade; and
- foster co-operation and co-ordination with persons or companies engaged in regulating, clearing, settling, processing information with respect to, and facilitating, transactions in derivatives.<sup>72</sup>

**(d) Prohibition against manipulative/fraudulent trading activity**

DTFs and their participants will be subject to a prohibition against engaging in, directly or indirectly, any act, practice or course of conduct relating to an OTC derivative that the person or company knew, or reasonably ought to have known, would (i) result in or contribute to a false or misleading appearance of trading activity in, or an artificial price for, an OTC derivative; (ii) perpetrate a fraud on any person or company, or (iii) be otherwise harmful to derivatives markets.

**(e) Financial resources**

A DTF operator would be required to demonstrate evidence of sufficient financial resources to fund the ongoing operation of the platform.

**(f) Personnel**

A DTF operator would be required to have sufficient qualified and competent personnel to ensure effective operation of the trading platform, including to ensure technology and system stability and conducting monitoring, and to respond to enquiries or complaints from platform participants without unreasonable delay. DTFs that have assumed responsibility for regulating conduct of their participants would be required to have sufficient qualified and competent

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<sup>72</sup> Compare ss. 5.3-5.4 of NI 21-101.

personnel to monitor trading on their trading platform, monitor compliance with their rules and applicable legislation, investigate suspected violations and bring enforcement action where appropriate.

**(g) Systems**

A DTF would be subject to system requirements similar to requirements applicable to marketplaces regulated under NI 21-101. For example, a DTF would be required to

- develop and maintain an adequate system of internal controls over its critical systems;
- develop and maintain adequate information technology general controls, including for example, controls relating to information systems operations, information security, change or problem management, and network and system software support;
- at least annually engage a qualified party to conduct an independent system review and prepare a report in accordance with established audit standards for each system that supports order entry, order routing, execution, trade reporting, trade comparison, data feeds, market surveillance, if applicable, clearing, and the information security controls of its auxiliary systems;
- develop and maintain robust contingency and business continuity procedures;
- at least annually, in accordance with prudent business practice, make current and future capacity estimates for its systems and conduct capacity stress tests of its critical systems to test their ability to process information in an accurate, timely and efficient manner and further, consistent with the requirements of NI 21-101 and proposed changes to it, advise the regulator of the hours of operation of any testing environment provided, a description of any differences between the testing environment and the production environment and the potential impact of these differences on the testing;
- be accessible by all platform participants subject to adequate safeguards and controls, to prevent unauthorised access;
- take reasonable steps to ensure that all participants have a reasonable opportunity to access trading systems without a time delay;
- maintain appropriate documentation of the systems operation and be able to provide such documentation to regulators upon request; and
- have transparent and publicly available documentation relating to on-boarding criteria and system interface requirements.

A DTF would be subject to additional obligations including being capable of reporting transactions involving Canadian counterparties to a trade repository recognized, designated, or exempt in Canada by the applicable local regulator. Although not all transactions on a DTF

would be required to be cleared, a DTF would be required to be capable of submitting all derivatives executed on its platform that were subject to mandatory clearing to a clearing agency recognized, designated, or exempt in Canada by the applicable local regulator, and fulfilling obligations placed on it by the clearing agency to ensure efficient and orderly execution of trades to be cleared, such as pre-trade credit limit verification.

In support of the trade reporting functionality described above and the record-keeping requirements described below, a DTF's systems would require

- the capability to assign a unique transaction identifier to each transaction executed on the DTF, to be used in publishing transaction information and in reporting the transaction to a trade repository or regulator, and in processing the transaction through a clearing agency; and
- the capability to time-stamp each activity in the transaction cycle, including order entry, amendments, cancellation, execution, transmission of information for clearing, and reporting to a trade repository.

#### **(h) Record-keeping**

A DTF would be required to keep, in electronic form, books, records and other documents reasonably necessary for the proper recording of its business, including the following:

- records of each grant, denial or limitation of access, as well as the reasons therefor;
- transactional records for all orders and trades, including cancellations or amendments of orders and trades, including prices, volume, counterparties, time order received, time trade executed, etc.;
- records of all bids and offers, RFQs, and replies to RFQs, including the time they were made available on the DTF;
- market statistical records, including historical prices, volume, high, low etc.;
- system records, including descriptions of system protocols, records of changes made to order management systems and transaction matching algorithms, results of system tests, and so forth; and
- records of all messages sent to or received from platform participants, including the identity of the participant involved, the instrument, the price, the volume and the time that the message was received or sent.

Consistent with requirements for marketplaces regulated under NI 21-101, a DTF would be required to keep these records for at least 7 years and in an easily retrievable format for at least the first 2 years. Upon request, these records would need to be made available to regulators as soon as practicable but in any event within 10 business days.

**(i) Conflicts of interest**

A DTF would be expected to establish, maintain and ensure compliance with policies and procedures that identify and manage any conflicts of interest arising from the operation of the DTF or the services it provides.<sup>73</sup> Among other things, this means that a DTF would be required to have appropriate corporate governance structures, policies and procedures to address any conflicts of interest resulting from the ownership or control of the platform or its parent entity. In particular, where the platform is owned by participants in the derivatives market, regulators would expect that the platform's policies will ensure that its owners will not have a competitive advantage as a result of their ownership stake. A DTF would be expected to have appropriate structures to ensure that the interests of all market participants are considered when the platform is making decisions relating to its operations.

The operator of a DTF would be prohibited from entering into trades as principal on its own account. This addresses concerns related to the DTF's access to privileged order information and other information in the system. However, a shareholder or other owner of a DTF should be allowed to trade on the DTF for its own account, subject to appropriate conflict-of-interest rules.

**(j) Disclosure by DTFs**

A DTF would be required to publicly disclose, on its website, information reasonably necessary to enable a person or company to understand the DTF's operations and the services it provides, including but not limited to information related to fees; how orders are entered, interact and are executed; access requirements; and policies and procedures designed to identify and manage conflicts of interest arising from the operation of the DTF or the services it provides.<sup>74</sup>

As discussed above in section 6, a DTF exercising discretion in trade execution would be required to disclose the nature and extent of that discretion.

**(k) Confidential treatment of trading information**

A DTF would be required to implement reasonable safeguards and procedures to protect a participant's order or trade information. Among other things, a DTF would be prohibited from releasing a participant's order or trade information to a person or company other than the participant, a securities regulatory authority or a regulation services provider unless the DTF participant has provided prior written consent to the release of the information; the release of information is required by applicable law; or the information has already been publicly and lawfully disclosed to another person or company. However, subject to certain conditions, we anticipate that a DTF would be permitted to release trading data for use in research.

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<sup>73</sup> Comparable to NI 21-101, s. 5.11.

<sup>74</sup> Comparable to NI 21-101, s. 10.1.

***Question 12: Are the proposed organizational and governance requirements for DTFs appropriate? Are there additional organizational and governance requirements that the Committee should consider?***

***Question 13: Is it appropriate that a DTF that does not exercise execution discretion be permitted to perform its regulatory and surveillance functions itself, or should it be required in all cases to engage a third-party regulation services provider for this purpose? Please explain.***

***Question 14: Do you agree with the proposal to prohibit DTF operators from entering into trades on their platforms as principals, on their own accounts? Please explain.***

***Question 15: How should the sufficiency of a DTF's financial resources be evaluated? Please comment on the methodology and frequency of the calculation.***

## **8. PRE-TRADE TRANSPARENCY**

Pre-trade transparency in the context of OTC derivatives refers to the extent to which participants are able to observe orders and quotations prior to transactions being executed. For market participants, pre-trade transparency improves the price formation process and allows participants to assess liquidity. Market participants need complete, timely, and accurate information about markets or products to assess the potential return and/or exposure to risk posed by a derivative. Accordingly, a lack of pre-trade transparency with respect to product characteristics or market conditions can result in an inability to properly evaluate the appropriateness of a price or value of a trade as well as the potential consequences of entering an order or quote. In most circumstances, pre-trade transparency fosters investor confidence and promotes a fair market.

On the other hand, requiring details such as trade size or size and price of quotes to be publicly disseminated in certain trading systems (for instance, an RFQ system) may disadvantage the entity seeking the quote or its potential counterparty by permitting the broader market to use that information in a way that disadvantages the entity seeking the quote or its potential counterparty. Further, pre-trade transparency information in relation to an illiquid product may not significantly assist in price formation. For example, if a market maker were required to maintain bid and ask prices for an illiquid product, the spread would likely be wider. The price posted would then not accurately reflect the available prices and one would need to call (or otherwise submit a request for quote) to establish these. Accordingly, the Committee recommends that pre-trade transparency requirements apply only to those products that are sufficiently liquid to ensure that the information is of benefit to market participants and the price formation process.

Given the significant differences between these markets and equity market structures, we expect that pre-trade transparency requirements will need to be calibrated to take into account specificities of OTC derivatives. In that regard, we note that presently liquidity providers in derivatives markets often provide liquidity on demand via RFQ systems as opposed to continuous firm quotes.

The US approach to pre-trade transparency is to (i) require SEFs to provide an order book on which market participants may make executable bids or offers which are displayed to all participants, (ii) require an RFQ to be disseminated to a minimum number of liquidity providers, and (iii) require dealers to “show” other market participants the terms of a prearranged order book trade between customers or between themselves and a customer through the 15-second rule.<sup>75</sup>

Large notional size swap transactions that would otherwise be required to trade through a SEF or DCM (i.e., block trades) are exempted from pre-trade transparency requirements, where they meet or exceed a minimum threshold. As a result, a block trade could, for example, be pre-arranged and executed away from the SEF’s order book.

In contrast to the CFTC approach of promoting pre-trade transparency, under MiFID II, the EU will require each regulated venue, including an OTF, to make public current bid and offer prices, and the depth of trading interests at those prices, for derivatives traded on its platform. An OTF must make this information available to the public on a continuous basis during normal trading hours; however, the requirement for public dissemination will not apply to hedging transactions.<sup>76</sup> The range of bids and offers, and the depth of trading interest at those prices, to be made public for each class of financial instrument, including derivatives, is to be specified by ESMA in forthcoming technical regulations.<sup>77</sup>

European regulators will have discretion to waive the obligation on OTFs and other trading venues to make public certain pre-trade information for any of the following:

- (1) orders that are large in scale compared to normal market size (block trades);
- (2) actionable indications of interest in RFQ and voice trading systems that are above a threshold size, calibrated specifically to the type of instrument, which would expose liquidity providers to undue risk;
- (3) derivatives not subject to the trading obligation;<sup>78</sup> and
- (4) other financial instruments for which there is not a liquid market.<sup>79</sup>

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<sup>75</sup> Pursuant to the 15-second rule, SEFs must require that brokers or dealers who have the ability to execute on a SEF’s order book against a customer’s order or to execute two customer orders against each other be subject to a 15-second timing delay between the entry of the two orders, such that one side of the potential transaction is disclosed and made available to other market participants before the second side of the potential transaction (whether for the trader’s own account or for a second customer) is submitted for execution.

<sup>76</sup> Defined as “derivatives transactions of non-financial counterparties which are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty or of that group”: MiFIR, Article 8 at s. 1.

<sup>77</sup> MiFIR, Article 9 at s. 5.

<sup>78</sup> I.e., the obligation to trade only on regulated markets, MTFs, OTFs, or equivalent foreign facilities.

<sup>79</sup> MiFIR, Article 9 at s. 1.

The Committee is of the view that requiring DTFs to publish pre-trade information for OTC derivatives that are not sufficiently standardized and liquid could have adverse and unintended consequences for the market and participants, including a negative impact on overall market liquidity. In the absence of a DTF-trading mandate for a particular derivative or class of derivatives, the Committee does not recommend requiring a DTF to provide a particular level of pre-trade transparency with respect to trading in that derivative. Nevertheless, if a DTF chooses to provide an execution method that inherently provides a certain degree of pre-trade transparency (for instance, a published order book),<sup>80</sup> the DTF would be required to provide the resulting pre-trade information in a manner that does not unreasonably prohibit, condition, or limit access by a participant or class of participants to such information. Further, the DTF will be required to report such information accurately and on a timely basis.

For trading in OTC derivatives that are subject to a DTF-trading mandate, the Committee recommends that DTFs be required to satisfy pre-trade transparency requirements, as discussed below in section 10.

***Question 16: Should pre-trade transparency requirements apply to OTC derivatives that trade on DTFs but that have not been mandated to be traded on DTFs? If yes, what requirements should apply, and should any exemptions be provided?***

## **9. POST-TRADE TRANSPARENCY**

Post-trade transparency in the context of OTC derivatives refers to the dissemination of price and volume information, other than to the executing parties, on completed transactions.

Although orders and quotes may help investors decide where and when to trade, prompt post-trade transparency helps market participants determine whether quotes are reliable, to assess the quality of the markets, and to assess execution costs. Without post-trade transparency, there may be few warnings of impending market trends. Market participants cannot respond quickly to selling or buying surges because they cannot see them happening as clearly or quickly. Most importantly, post-trade transparency can help market participants assess liquidity in a given market.

In the US, SEFs are required to make public “timely information on price, trading volume, and other trading data on swaps to the extent prescribed by the Commission”. Trades are to be reported to a swap data repository “as soon as technologically practicable” after execution.<sup>81</sup> In turn, the swap data repository must publish the information as soon as technologically practicable. Certain market information must also be made “readily available to the news media and the general public without charge, in a format that readily enables the consolidation of such data, no later than the business day following the day to which the information pertains.”

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<sup>80</sup> Although a firm quote in response to a request for quote might be considered to be an order for the purposes of subsection 7.1(1) of NI 21-101, the Committee would likely not recommend that pre-trade transparency be required from DTFs in the situation where a quote is provided only to the requesting party.

<sup>81</sup> CFTC Regulation, s. 37.900 and s. 43.3.



Under the SEF regime, block trades benefit from a delay in public dissemination of trade data. The length of the delay varies depending on the counterparty type and whether or not the swap is subject to mandatory clearing; block trade delays are subject to an initial phase-in period. For swaps subject to mandatory clearing involving at least one counterparty that is a swap dealer, the delay in the public dissemination of swap transaction data will ultimately be 15 minutes from the time of execution. The block trade rule also establishes “cap sizes” for notional and principal amounts that will mask the total actual notional size of a swap transaction if it exceeds the cap size for a given swap category. The notional size of such a trade will be reported as larger than the cap size, rather than as a particular notional amount.

The approach in the EU is very similar. Specifically, OTFs and other trading venues are required to make public the price, volume and time of transactions executed in respect of derivatives traded on an OTF or other trading venue, and to make these details public in “as close to real-time as is technically possible” and “on a reasonable commercial basis”.<sup>82</sup> The information must then be made available to the public “free of charge 15 minutes after publication”.<sup>83</sup> However, regulators will be able to authorize an OTF to defer publication of this information for transactions that are (i) large in scale compared with the normal market size for the derivative, or the class of derivative, being traded (e.g. block trades); (ii) related to derivatives, or a class of derivatives, for which there is not a liquid market; or (iii) above a threshold size, calibrated specifically to the derivative or class of derivative, which would expose liquidity providers to undue risk, taking into account whether the relevant market participants are retail or wholesale investors.<sup>84</sup> The ESMA is to provide further information regarding the meaning of “as close to real-time as is technically possible”, and the length of delay that will be allowed for the deferred publication of post-trade information.<sup>85</sup>

With respect to post-trade transparency, the Committee recommends that DTFs be required to report to the public transactions executed on the DTF in as close to real-time as technically feasible. The Committee is considering the best method to achieve the public dissemination of transactions on a DTF, whether by requiring a DTF to disseminate the transaction data to the public directly, or by requiring a DTF to report the transactions to a trade repository, and requiring the trade repository to disseminate the trade data to the public.<sup>86</sup> In either case, deferred publication of this information would be permitted in certain circumstances, such as for block trades.<sup>87</sup> Additionally, the Committee recommends that DTFs be required to provide certain market information, to be determined by the Committee,<sup>88</sup> to the general public at no charge on a

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<sup>82</sup> MiFIR, Article 10, s. 1; Article 13, s. 1.

<sup>83</sup> MiFIR, Article 13, s. 1.

<sup>84</sup> MiFIR, Article 11, s. 1.

<sup>85</sup> MiFIR, Article 11, s. 4.

<sup>86</sup> Cf. CFTC Regulations, §43.3, Method and timing for real-time public reporting.

<sup>87</sup> The deferral would take place either at the DTF, before reporting the trade to the trade repository, or at the trade repository, as is the case in the US.

<sup>88</sup> See Question 21, below.

delayed basis (e.g., the next business day). Although not required to, a DTF would not be prohibited from disseminating real-time data.<sup>89</sup>

In addition to a DTF's public reporting obligation, and especially in the event that a DTF is permitted to fulfill its public reporting obligation by reporting trade data to a trade repository, the Committee is also considering whether a DTF should be required to disseminate all transactions on the DTF directly to all its participants, in addition to reporting the transactions to a trade repository.

Separate from the post-trade transparency requirements described above, the Committee recommends that DTFs be required to provide information relating to a trade to the participants involved in that trade, at no additional cost to those participants.

***Question 17: Are the proposed post-trade transparency requirements (involving real-time trade reporting as well as public reporting of certain daily data) appropriate for DTFs?***

***Question 18: What is the preferred method for real-time public reporting of transactions executed on a DTF (i.e., directly by a DTF, via trade repositories, or some other method)? What are the advantages and disadvantages of the proposed options?***

***Question 19: When should deferred publication of trade information be permitted? Are there circumstances other than block trades?***

***Question 20: Assuming that deferred publication of trade information should be permitted for block trades, what criteria should be considered when determining the minimum block trade threshold size to permit deferred trade disclosure?***

***Question 21: What market information should a DTF be required to provide to the general public without charge, and on what schedule? Please be as specific as possible as to data elements, granularity, and schedule (compare with the US CFTC rules in 17 CFR 16.01).***

***Question 22: In addition to reporting trade information to a trade repository, should a DTF be required to disseminate trade information directly to all its participants, or only to the counterparties to the trade? Should there be a minimum amount of post-trade information that is disseminated to all participants, containing less detail than the information provided to the counterparties? Please specify.***

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<sup>89</sup> However, the Committee recognizes that it may not be desirable for a DTF to publish trade information *sooner* than that same information can be published by a trade repository, as this may create unintended incentives. The Committee recommends addressing this situation should the potential for it arise.

## 10. TRADING MANDATE

### (a) Mandating OTC derivatives to be traded on an organized platform

The Committee recommends that sufficiently liquid and standardized OTC derivatives be subject to a requirement to be traded exclusively through a DTF.

At the present time, the Committee does not believe it has sufficient data with respect to liquidity levels in the OTC derivatives market in Canada to be able to assess whether the introduction of mandatory DTF trading for a particular class of OTC derivatives would be appropriate. Similarly, the Committee at present has insufficient data with respect to volume and turnover in OTC derivatives of various asset classes in Canada and the extent to which transactions in such asset classes are currently being executed electronically or on multilateral platforms. We anticipate being in a position to recommend particular OTC derivatives as suitable for mandatory DTF-trading after trade reporting and clearing obligations have been in effect for a period of time and the members of the CSA have had sufficient time to analyze the resulting data and consult with other Canadian authorities and the public. We anticipate further that such analysis will be repeated periodically, with a view to requiring additional derivatives to be traded through a DTF when conditions warrant, and possibly to removing derivatives that no longer meet the criteria for mandatory trading on a DTF.

The Committee is monitoring and will continue to monitor developments in the marketplace in respect of the trading mandate that has recently come into effect in the US for certain interest rate and credit derivatives. The Committee will closely gauge the level of adoption and the consequences, intended or otherwise, of the DTF-trading mandate on OTC derivatives markets.

In considering whether to require that a class of derivatives be traded exclusively through a DTF, the Committee proposes that regulators consider whether the class of derivative is

- subject to a clearing obligation pursuant to applicable securities legislation, which topic has been addressed by the Committee in CSA Consultation Paper 91-406 *Derivatives: OTC Central Counterparty Clearing*, published June 2012 and CSA Staff Notice 91-303 *Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives*, published December 2013;
- sufficiently liquid to trade exclusively through a DTF, having regard to factors including the average volume, frequency and size of trades; the number and characteristics of active market participants; and the characteristics of the derivative, including degree of standardization;
- traded by a sufficient number of regularly-participating market participants to ensure that the market is competitive and not susceptible to control by a small number of participants;
- mandated to be traded on a regulated venue in other jurisdictions; and

- already trading through the facilities of a DTF and, if so, the execution method in use for that class of derivatives.

This approach aligns with the procedure in the EU for determining whether a derivative will be subject to a platform-trading mandate (discussed above in section 2). This approach is also like that adopted in the US, in that it would take into account whether an OTC derivative, or class of OTC derivative, has already been made available to trade through the facilities of a DTF.

The Committee recommends that, where a derivative has been mandated to trade exclusively on a DTF, the mandate apply to all trading activity by all market participants. It is anticipated that this would maximize the liquidity and transparency benefits from shifting trading to centralized platforms. However, the Committee would like to learn whether there are any situations in which a product that has been mandated to trade exclusively on a DTF should nevertheless be permitted to trade other than on a DTF (or other exchange that has been authorized to trade in OTC derivatives).

***Question 23: Are the proposed criteria for determining whether a derivative will be subject to a DTF-trading mandate appropriate? Should other criteria be considered?***

***Question 24: Are there existing OTC derivatives that should be considered suitable for mandatory trading on a DTF? Are there classes of OTC derivatives for which a mandatory trading obligation would be detrimental to market participants?***

***Question 25: Are there any situations in which a product that has been mandated to trade exclusively on a DTF should be permitted to trade other than on a DTF? Should any category of market participants be exempt from a trading mandate?***

***Question 26: Should there be a formal role for DTFs in initiating the process to specify that a class of OTC derivatives is mandated to trade exclusively on a DTF, comparable to the role of SEFs in the MAT process described on page 19?***

#### **(b) Enhanced requirements where derivatives are subject to a DTF-trading mandate**

The Committee is considering additional, enhanced requirements for DTFs that offer trading in a class of derivatives that is the subject of a DTF-trading mandate.

First, the Committee recommends that a DTF be required to disclose to its users accurate and timely bid and offer prices, as well as market depth at each price level, with respect to derivatives subject to a DTF-trading mandate.

However, the Committee anticipates that pre-trade transparency requirements imposed in respect of derivatives subject to a DTF-trading mandate may need to be tailored for the execution methods employed on the DTF. For instance, for trading via RFQ, the requests and quotes are only between the requester and the interrogated dealers so that, if pre-trade transparency is to be achieved in an RFQ market, it would have to be through such measures as a requirement for an RFQ to be sent to a minimum number of unaffiliated dealers, as described below.

Pre-trade transparency requirements might also take into account transaction size, including turnover, and other relevant criteria. However, such customization may not be necessary if the range of execution methods is limited for trading in OTC derivatives subject to a DTF-trading mandate.

The Committee recommends that CSA members exempt orders and quotes from pre-trade transparency requirements (or perhaps permit modified disclosure that masks the size of the order or quote) where an order or quote is sufficiently large in scale relative to normal market conditions (specific to the instrument) such that it would expose liquidity providers to undue risk. The Committee is continuing to assess what size threshold would be appropriate for the Canadian OTC derivatives market, recognizing that what is appropriate may vary depending on the liquidity of a particular product.

In addition to an enhanced pre-trade transparency requirement for trading in derivatives subject to a DTF-trading mandate, the Committee is also considering whether to require a DTF that offers trading in a mandated product to provide a minimum order book functionality—comparable to that required of SEFs—so as to enable market participants to make executable bids and offers, and display those bids and offers to all other market participants on the DTF. The requirement for an order book would help to ensure an appropriate degree of pre-trade transparency is provided for OTC derivatives that are subject to a DTF-trading mandate.

The Committee is also considering permitting trading in OTC derivatives subject to a DTF-trading mandate to occur by way of an RFQ system in conjunction with an order book. The Committee contemplates that an acceptable level of pre-trade transparency may be provided where an RFQ is communicated to an appropriate number of unaffiliated participants, and responses to the request, together with matching bids or offers resting on the associated order book, are communicated to the requester. As on a SEF, the Committee contemplates that transactions could be executed exclusively through the RFQ system (i.e., off-order book) on the basis that pre-trade transparency would be provided by virtue of the RFQ functionality and the *existence* of a transparent order book which could encourage orders to compete with quotes.

The Committee contemplates that even if an order book, or hybrid order book and RFQ system, were required for trading in derivatives subject to a DTF-trading mandate, market participants would retain the option to pre-arrange transactions in OTC derivatives that have been mandated to trade—that is, to negotiate on a bilateral basis, separate and apart from the order book or RFQ system—provided that the order was both executed through the order book and subject to an appropriate time-delay. This requirement would be comparable to the 15-second rule applicable to order book trading on SEFs, referenced above in section 8. The underlying policy objective of the time delay is to “expose” the trade to the market prior to execution to allow the market to compete on one side of that trade.

***Question 27: What pre-trade transparency requirements are appropriate for OTC derivatives that have been mandated to be traded on a DTF? In particular, what precise pre-trade information should a DTF be required to publish for OTC derivatives that are subject to a DTF-trading mandate? Please be specific in terms of the execution method (e.g., order book, RFQ, etc.).***

**Question 28:** *For the purpose of exempting large orders and quotes from pre-trade transparency requirements or permitting modified disclosure, how should an appropriate size threshold be determined?*

**Question 29:** *Is it appropriate to limit trading in OTC derivatives that have been mandated to be traded on a DTF to specific permitted execution methods, e.g., an order book, or a request-for-quote system offered in conjunction with an order book? Why or why not? If so, which modes of execution should be permitted for products that are mandated to trade on a DTF? Can an appropriate level of pre-trade transparency be achieved with other methods of execution? What other factors should be considered?*

**Question 30:** *What additional requirements should apply to DTFs with respect to trading in products that have been mandated to trade on a DTF?*

**Question 31:** *Please describe any specific characteristics of the Canadian OTC derivatives markets that the Committee should consider, which might justify a divergence between Canadian rules and those in effect in the US and the EU. Please consider transparency requirements, the trading mandate, and anything else you think relevant. Please refer to specific consequences of the characteristics you identify.*

## **11. FOREIGN-BASED DTFs**

The Committee recommends that a foreign-based DTF, such as a SEF or OTF, that provides Canadian participants with direct access<sup>90</sup> to their trading platforms be subject to the requirements of the proposed DTF regulatory regime. A foreign DTF would be required to be authorized, or exempted from authorization, in each local jurisdiction of Canada in which it provides a local participant with direct access. However, the Committee recommends that CSA members consider exemptions for foreign-based DTFs, on a case-by-case basis, from some or all of the requirements of the DTF regime if the foreign-based DTF is able to demonstrate that the regulation and oversight in its home jurisdiction is comparable to that which would apply under the proposed DTF regulatory regime. In such cases the Committee recommends that CSA members consider relying on the day-to-day oversight by the home regulator of the foreign-based DTF, generally limiting direct oversight to matters of particular local importance.<sup>91</sup> The foreign-based DTF would still be subject to reporting obligations to Canadian securities regulators with respect to services provided to local participants.

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<sup>90</sup> In this context, “direct access” means that a participant may transmit orders and enter trades directly onto a DTF without intermediation by another participant.

<sup>91</sup> CSA members might retain discretion to oversee such matters as fair access and compliance with Canadian market integrity requirements.