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## OSC ISSUES STAFF NOTICE REGARDING OFFERINGS OF CONTRACTS FOR DIFFERENCE

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The Ontario Securities Commission (the "OSC") has recently issued Staff Notice 91-702 – "Offerings of Contracts for Difference and Foreign Exchange Contracts to Investors in Ontario" (the "Notice"). The Notice was issued in response to inquiries from market participants regarding the applicability of Ontario's securities laws to the distribution of "over-the-counter" derivative products ("OTC Derivatives"), in particular a financial product known as "contracts for difference" ("CFDs"). The OSC has concluded that CFDs are "securities" within the meaning of the *Securities Act* (Ontario) (the "Act") and that CFD issuers that wish to offer CFDs to investors in Ontario, absent statutory exemptions or exemptive relief, are required to comply with the registration and prospectus requirements of Ontario securities law.

### Inside

|   |   |
|---|---|
| <b>Canadian Securities Administrators</b> ..... | 3 |
| <b>IIROC</b> .....                              | 4 |
| <b>ICE Futures Canada</b> ....                  | 4 |
| <b>Canadian National Stock Exchange</b> .....   | 4 |
| <b>TSX Venture Exchange</b>                     | 4 |
| <b>Montreal Exchange</b> ....                   | 4 |
| <b>Provincial Updates</b>                       |   |
| Alberta .....                                   | 4 |
| British Columbia .....                          | 4 |
| New Brunswick .....                             | 5 |
| Newfoundland and Labrador .....                 | 5 |
| Nova Scotia .....                               | 5 |
| Ontario .....                                   | 5 |
| Saskatchewan .....                              | 6 |
| <b>Recent Cases</b>                             |   |
| Adviser registration.....                       | 6 |
| Sanctions and costs....                         | 7 |

The Notice is intended to provide interim guidance pending the development by the Canadian Securities Administrators of a harmonized approach to the regulation of OTC Derivatives and/or the introduction of new or revised derivatives legislation in Ontario or federally.

## What are CFDs?

CFDs are derivative products that allow an investor to obtain economic exposure to an underlying asset, such as an equity security, bond, capital market index, foreign currency or commodity, without acquiring ownership of the underlying asset. A CFD is a private contract between an investor and a CFD issuer that creates future payment obligations based on the price movements of the underlying assets. Investors can take long (or short) positions in relation to the underlying asset and can benefit (or lose) from upward price movements of the underlying asset.<sup>1</sup>

CFDs differ from futures contracts<sup>2</sup>, and are more comparable to forward contracts<sup>3</sup> in that CFDs are not standardized contracts and are not exchange-traded in Canada. In addition, CFDs and forward contracts can expose investors to some counterparty risk that is not present with exchange-traded futures contracts or purchases or sales of listed shares since neither CFDs nor forward contracts are settled through a central clearing house. Unlike forward contracts, however, CFDs have no fixed expiry date and are settled exclusively in cash rather than by way of the physical delivery of the underlying or subject

asset. Another difference from forward contracts is that CFDs are marked to market (similar to futures contracts), which reduces counterparty risk.

## Margin and Synthetic Leverage

One of the principal features of investing in CFDs is that there are typically low “margin” requirements. Often an investment dealer may provide a loan to an investor to purchase a stock which thereby allows an investor to purchase a stock without using the investor’s capital as the only source of capital to finance the purchase (this is referred to as a “margin loan” or “buying a stock on margin”). In the case of CFDs, the “margin” requirement is instead referring to the amount of capital that an investor must provide to the CFD issuer in order for the investor to enter into the CFD contract; therefore, with CFDs there are no loans. Rather, the “margin” requirement for a CFD is the amount of the investor’s capital that the investor must maintain in its account in regard to the CFD contract. The “margin” requirement is designed to protect the CFD issuer against price movements in the underlying asset that result in losses to the investor (and credit risk to the CFD issuer and account provider).<sup>4</sup> As a result of the low “margin” requirements (as compared to purchasing the underlying stock), investors that purchase CFDs gain access to potential returns (positive or negative) that are greater as compared to investing in the underlying asset (even if it had been purchased on margin). Therefore, the use of CFDs can expose an investor to greater potential gains and losses with less of the investor’s initial capital being required. Therefore, CFDs are likely appealing to investors that wish to either hedge against certain financial risks or make a short-term, potentially high yielding speculative investment regarding the direction of short term price fluctuations.

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## CFDs in Canada

CFDs are currently being offered in a number of foreign jurisdictions and are also being offered to investors, including retail investors, in Canada through internet forums operated by CFD providers. The OSC is of the opinion that CFDs raise a variety of investor protection concerns, including concerns related to: the use of margin or leverage; the complexity of CFDs and the adequacy of disclosure documents; suitability determinations undertaken by CFD providers; and counterparty risk.

Given the characteristics of CFDs (which allow an investor to simulate a direct investment in an underlying asset, usually a listed common share, at less cost but with an increased investment yield exposure), the OSC is of the view that the appropriate category of registration for dealers trading in or issuing CFDs is “investment dealer”, which requires membership in the Investment Industry

Regulatory Organization of Canada (“IIROC”). As a registrant and an IIROC member, a CFD provider is subject to certain prescribed minimum margin rates for CFDs and is obligated to perform know your client and suitability determinations.<sup>5</sup>

Since disclosure about the underlying asset is an integral portion of the material information concerning any CFD, and since the issuer of any underlying security or asset is not a party to the CFD, the OSC acknowledges that the prospectus requirement may not be well-suited to offerings of CFDs and may grant exemptive relief where, among other things, investors are provided with a risk disclosure statement explaining the product and the risks associated with an investment in the product. The OSC granted such an exemption to CMC Markets UK and CMC Markets Canada Inc. on October 8, 2009<sup>6</sup> and will consider further exemption applications on a case by case basis. It should be noted, however, that investors purchasing CFDs offered under such exemptions will not benefit from the detailed and current disclosure found in a prospectus or the statutory rights of action available to purchasers of securities offered under a prospectus. In addition, the holders of CFDs will not benefit from typical corporate law mechanisms or protections such as the ability to vote shares, make claims pursuant to the oppression remedy or exercise dissent rights.

## Insider Trading and Reporting

The Notice also reminds market participants that the prohibitions against insider trading and tipping found in the Act are applicable to CFD transactions. Therefore, insiders and any other persons in a special relationship with a reporting issuer must not purchase (or sell) CFDs involving, directly or indirectly, securities of that reporting issuer while the investor has knowledge of any material information that has not been publicly disclosed. Insider reporting requirements through SEDI will also apply to any insider’s relevant CFD transactions.

For more information on the subject of this bulletin, please contact the authors or any member of Fasken Martineau’s Securities and Mergers & Acquisitions Group.

### Notes:

<sup>1</sup> The payoffs would be reversed if there were a downward price movement in the underlying asset.

<sup>2</sup> A futures contract is a contract in which the seller agrees to deliver a specified commodity or financial instrument at a specified price sometime in the future. A futures contract is traded on a recognized exchange and the terms of a futures contract are standardized by the applicable exchange.

<sup>3</sup> A forward contract is a contract in which the seller agrees to deliver a specified commodity or financial instrument at a specified price sometime in the future. The terms of a forward contract are not standardized but are negotiated at the time of the trade. Forward contracts trade, if at all, on an

OTC basis and as a result there may be no or a limited secondary market for a forward contract.

<sup>4</sup> If the investor suffers losses on the CFD, the CFD issuer will require that the investor put up further margin to cover potential future losses.

<sup>5</sup> IIROC rules exempt member firms that provide execution-only services such as discount brokerage from the obligation to determine whether each trade is suitable for the client but require that an initial suitability determination is made.

<sup>6</sup> The exemptive relief order granted in this situation requires that CMC Markets UK and CMC Markets Canada conduct offerings of CFDs in accordance with the rules and regulations of the *Derivatives Act* (Québec) and l’Autorité des marchés financiers (to the extent that such rules and regulations are not inconsistent with Ontario securities laws or IIROC rules and acceptable practices). A copy of the exemptive relief order can be found on the OSC website at: [http://osc.gov.on.ca/en/SecuritiesLaw\\_ord\\_20091016\\_224.CMCMarketsUK%20.jsp](http://osc.gov.on.ca/en/SecuritiesLaw_ord_20091016_224.CMCMarketsUK%20.jsp). Please also see the exemptive relief order of the Autorité des marchés financiers No. 2009-PDG-0064.