

THE MANITOBA SECURITIES COMMISSION

NOTICE 2000-36

THE COMMODITY FUTURES ACT - RULE

Notice 2000-15 was issued by The Manitoba Securities Commission on May 15, 2000. The Notice requested comments and submissions on the proposed commission rule dealing with regulatory requirements under *The Commodity Futures Act* S.M. 1996, c.73 (the "Act").

The Notice provided that written submissions were to be made to the Commission on or before July 23, 2000. The Commission received submissions from seven parties. Schedule "A" provides a list of the parties that provided comments.

The purpose of this Notice is to summarize the matters raised in the submissions and to provide the Commission's response to each of these matters. In addition an amended final version of the rule is being published with this notice. The Commission has determined that the amendments made to the previously published rule are not material and that there is no requirement to publish for further comment pursuant to clause 5 of Manitoba Regulation 180/99 (the Commodity Futures Rule-Making Procedure Regulation). The rule will be enacted as of the date of publication in the Manitoba Gazette. This is anticipated to be September 30, 2000.

1. Rule 2.4(3) Discretionary accounts

Comments received

The rule as presently drafted treats all accounts of a futures commission merchant where discretion is exercised on behalf of a client in the same way. The rule includes requirements for registration as a contracts portfolio manager or an associate contracts portfolio manager in order to conduct any form of discretionary trading. Although these categories of registration mirror the requirements of the Investment Dealers Association ("IDA"), the IDA registration requirements apply only to managed accounts. The IDA rules make a distinction between *discretionary* and *managed* accounts.

In general terms, a *discretionary* account is defined by the IDA as an account where trading decisions can be made by the registrant for the client in situations where, because of absence or illness, the client cannot be contacted. There are monthly reviews of the trading activities in discretionary accounts.

A *managed* account involves active ongoing management of trading decisions within the account by the registrant. As it is the registrant that is exercising discretion for trading decisions on the account the requirements for additional experience, qualifications and supervision apply.

Six comments were made that the requirements relating to discretionary accounts as set out in the rule are being applied too broadly by including in the definition of a discretionary account "any discretionary authority" except where "the sole reason that discretion is exercised as to the price at which or time when an order given by the customer for the purchase or sale of a definite amount of a specified contract is executed". In effect, the concern raised is that the rule applies the IDA requirements relating to *managed* accounts to *discretionary* accounts.

Comment was also made that the rule fails to make the distinction between a situation where discretion has been unsolicited (a discretionary account) and where the registrant has offered service to the client on the basis the registrant will exercise discretion (a managed account). Comment was made that the motives or intention of the client as to how the account will be handled are different in each of these situations and should be treated differently in the rule.

Commission response

The rule as presently drafted is consistent with the IDA requirements for managed accounts, but is not consistent with the IDA requirements for discretionary accounts. The concern of Commission staff is that registrants may be applying the IDA rules for discretionary accounts too broadly, exercising discretion on a client's account where such discretion is not authorized. As an example one submission stated discretion could be exercised by a registrant as a "convenience for a client who is hard to get ahold of from time to time". It is the view of staff that this description of discretionary trading is too broad and that discretionary trading should not be conducted on the basis of "convenience".

However, the Commission also acknowledges that the present wording of the rule prohibiting any discretion from being exercised in an account could be detrimental to a client's best interests by preventing a registrant from conducting trades required to minimize a loss at a time a client cannot be contacted. In such a situation the registrant would be required to make reasonable efforts to contact the client as well as discussing the matter and confirming the activities with the registrant's firm and the client.

The Commission considered the possibility of amending the rule to include requirements for both discretionary and managed accounts. However, given the difficulty in applying the concept of a discretionary account and determining when discretion can be exercised, the Commission determined this approach was not appropriate.

In order to avoid registrants being subject to two potentially different standards, the rule has been amended to exempt members of a self regulatory organization recognized by the Commission under section 14 of the Act from the requirements contained in sections 3.31 and 3.32 of the rule. At present the Commission has received application from the Winnipeg Commodity Exchange for recognition as a self-regulatory organization pursuant to section 14 of the Act.

The rule will continue to require Futures Contracts Portfolio Managers and Associate Futures Contracts Portfolio Managers to be registered with the Commission. The Commission takes the view that the requirements for registration are in the public interest and are necessary to ensure adequate proficiency required to make the trading decisions required to manage accounts.

2. *Rule 3.11 to 3.14 Proficiency requirements for registration*

Comments received

Four comments were made that the rule should contain grandfathering provisions. An applicant for registration that had successfully completed courses that are no longer offered should not be denied registration if that applicant can demonstrate to the Commission the required proficiency to trade in contracts.

Two comments were made that the rule does not include a limited form of registration for trading activities in the case of the management of mutual funds where trading is conducted for limited purposes. Comment was made that completion of Chartered Financial Analyst courses would provide the necessary proficiency to conduct the limited nature of trading required.

Although the rule permits the director of the Commission to exempt an applicant for registration from any of the proficiency requirements contained in section 3.12 to 3.14 of the rule, comment was made that requiring an application for exemption would impose a burden on registrants and possibly would lead to delays in the registration process.

Reference was also made to Part II - IDA Policy No. 6 which provides exemptions from specified course requirements where an applicant has met specified criteria.

Commission response

The rule was drafted to provide the director of the Commission with a broad discretion to exempt an applicant for registration from one or more of the proficiency requirements. Although described as an exemption, it was at all times intended that the request for an exemption would be considered as part of the review of a registration application. Although applicants will be required to provide written reasons to support a request for an exemption, no separate exemption application will be required and no additional fee will be payable to the Commission.

The basis for the exercise of the discretion to exempt an applicant for registration from one or more of the proficiency requirements would be a review as to whether the applicant for registration had a combination of experience and education that demonstrates that the granting of the exemption would not be contrary to the public interest. The IDA policy will be one of the factors in that review.

Consideration was given to drafting the rule to specify specific courses and levels of experience that would permit an exemption from one or more of the proficiency requirements in the rule. However, as the registration requirements are new to most market participants in Manitoba, it was determined that it would be difficult to identify in the rule all of the factors that would justify the granting of an exemption from a proficiency requirement.

The proficiency requirements contained in the rule are intended to establish a minimum standard for industry participants. It is the intention of the Commission to apply the proficiency standards as contained in the rule to applicants who enter the industry.

3. *Rule 3.13 Options licensing course*

Comments received

Four comments stated that the requirements of the rule are inconsistent with IDA requirements. IDA Regulation 1900 does not require an applicant for registration to have completed the Options Licensing Course unless that person is trading in options. Options are defined in the IDA regulation as "a call or put option issued by Trans Canada Options Inc., Intermarket Services Inc., The Options Clearing Corporation, Intermarket Clearing Corporation, International Options Clearing Corporation or any other corporation or organization recognized by the Board of Directors for the purposes of this Regulation but "option" does not include a futures contract or futures contract option as defined in Regulation 1800.1".

Two comments questioned the need for the requirement in 3.13(2) for branch managers to complete the Options supervisors course as well as the requirement contained in 3.13(3) that partners or officers of an FCM complete the Options licensing course.

Commission response

The jurisdiction of the Commission under the Act is limited to "contracts". A contract is defined to mean a commodity futures contract and a commodity futures option. A commodity futures contract is defined to include only contracts entered into on a commodity futures exchange. A commodity futures option is defined to refer to options on commodity futures contracts entered into in accordance with the internal regulations of a commodity futures exchange.

The registration requirements contained in section 24 of the Act apply to the trading or advising in contracts. The rule as presently drafted is consistent with the Act to the extent the Act does not make a distinction in registration categories for the trading of commodity futures contracts as opposed to commodity futures options.

The Act and rule provide discretion to place terms and conditions on a registration. In addition, as discussed above the rules permit the director to exempt an applicant for registration from a proficiency requirement contained in the Act.

The Act and rules would permit a dealer, local or advisor to be granted registration with conditions limiting the trading or advising to commodity futures contracts. By limiting a registration to the trading or advising in commodity futures contracts (and excluding commodity futures options), the need for completion of the Options Licensing Course is eliminated.

As a result the Commission sees no need to amend the rule to deal with the comment.

4. *Rule 3.16(1) Number staff*

Comments received

Three comments were received that stated the rule does not provide for contract representatives to accept client orders. The IDA provides for identifying contract representatives to accept orders. One commentator objected to permitting non-qualified employees from accepting unsolicited orders.

The IDA requirement that there be two persons to serve customers at any time is inconsistent with the requirement imposed by the rule.

In addition, the present wording of 3.16 does not include a requirement to specify an individual as a branch manager for an office.

Commission response

With respect to the comment that non-qualified persons should not be permitted to accept unsolicited customer orders the Commission considered various options as to what level of staffing would be required by a registrant. Consideration was given to the need of customers to receive an adequate level of service, the need to have sufficient resources to supervise and review activities within an office and the need to ensure the requirements of the rule do not create excessive costs for registrants.

In response to the comment raised about the use of non-registered persons to accept orders section 25 of the Act provides that the director can designate any employee or class of employee as non-trading. The designation can also be cancelled. It is the view of the Commission that these provisions limit the risk to the public that may be created by the use of non-registered persons by requiring both disclosure of those persons as well as requiring disclosure of the activities conducted by the non-trading employee. It is the view of the Commission that the accountability and public interest objectives of registration are not compromised by this approach.

The Commission has amended 3.16 to include a requirement that one of two individuals referred to in 3.16(1)(a) will be identified as the branch manager.

5. *Rule 3.17 Requirement for membership with Winnipeg Commodity Exchange*

Comments received

Two comments stated the requirement for membership with the WCE is unnecessary for firms that do not conduct business on the WCE or for firms that only conduct limited trading activity for specific purposes. In addition, the comments stated the requirement for WCE membership imposes a duplication in regulations on firms that are presently registered with the Commission under *The Securities Act*.

Commission response

The Act permits the commission to recognize a self regulatory organization that is charged with the regulation of the activities of its members. As the WCE is the only organization that has applied to the Commission for recognition as a self-regulatory organization a review of the WCE application for recognition will include a review of the requirements imposed by that organization on its members. This is not a duplication of regulation, it is a recognition of the role of the Commission and of the WCE in the overall regulatory process.

The Commission is prepared to consider applications for exemption from this requirement in limited circumstances where the applicant can demonstrate that the trading of contracts is incidental to the primary business of the applicant and that the applicant is subject to regulatory oversight which is consistent with the regulatory requirements that would apply to the applicant if it was a member of the WCE. The Commission is not prepared to consider exemptions solely based on an applicant trading in contracts on an exchange other than the WCE.

6. *Rule 3.20(5) Joint Regulatory Financial Questionnaire*

Comment received

The rule requires financial reporting with the Commission within seven business days after the end of the month.

Three comments expressed concern that it would be difficult to comply with the requirement to provide reports to the Commission within seven business days. Although it was acknowledged that registrants would have access to trading information the other financial information required by the form may not be available as quickly.

Commission response

The rule has been amended to require the information to be filed within twenty business days following the end of the month. This is consistent with requirements imposed by the IDA.

7. *Filing of financial information*

Comments received

Two comments recommended the Commission obtain the required filings directly from the IDA.

One comment questioned the need for filings with the Commission given the role of the Canadian Investor Protection Fund ("CIPF") and the agreement between CIPF and the Commission under which CIPF agrees to provide information to the Commission in the event of a capital transfer or capital deficiency of a CIPF member.

Commission response

The Commission recognizes and acknowledges the role of CIPF in the administration of the fund and in conducting reviews of its members. However, the Commission must also be in a position to act independently of CIPF on any issue that involves the activities and/or solvency of a registrant. The agreement with CIPF does not limit the jurisdiction or the responsibility of the Commission to regulate and take action against a registrant.

The Commission is of the view that the filing requirements provide an important tool for the Commission in carrying out its regulatory responsibilities. The rule was drafted to make these filing requirements consistent with what is to be filed with other regulatory agencies. Although coordinating the filings at a single source would be preferable, there is no mechanism in place at this time to achieve this result.

As a result Commission is not in a position at this time to forego the filing of financial information from registrants.

8. *Rule 3.20(6) Capital Filings*

Comments received

Three comments expressed concern that the requirement in the rule to make filings with the Commission within 42 days was inconsistent with the IDA requirement for filing within 35 business days.

Commission response

The rule has been amended.

9. *Rule 3.21(5)*

Reads "The registration of a futures commission merchant is automatically suspended if the futures commission merchant does meet the requirements of this section for any reason"

Comment received

One comment stated the word *not* should be inserted after *does*.

Commission response

This rule has been amended to correct the error.

10. Rule 3.22(5) Retention and storage of records**Comment received**

One comment requested that the rule be amended to permit records to be kept in storage at any time. The rule does not presently permit records to be sent to storage until after a period of two years.

Commission response

In many situations investigative and compliance staff of the Commission require immediate access to records. In addition, firms require access to records to deal with client inquiries and complaints. The two year period is intended to balance the need for immediate access to records while acknowledging that requiring the retention of records within the offices of a firm for an extended period of time is not practicable.

The Commission does not propose amending the rule.

11. Rule 3.26 FCM Trade Allocation

The rule requires FCMs to establish and maintain policies directed at ensuring fairness in the allocation of trading opportunities among customers.

Comments received

Two comments suggested this section be removed. The basis for this suggestion was that FCM's do not allocate trading opportunities.

Commission response

An FCM can be faced with multiple orders being placed by two or more customers. In many cases, particularly in an active market, several customers may provide the FCM with instructions at essentially the same time. In order to protect the interests of the customers of the FCM there is a need to ensure that the FCM will process the multiple orders in a fair and efficient manner. Trading practices which give the orders of one customer preference over another on the basis of the identity of the customer, and not on the basis of the time the instructions were given, can result in prejudice to one or more customer.

The Commission is not prepared to amend the section.

12. Rule 3.27**Comment received**

One comment noted there is no 3.27 in the rule.

Commission response

The numbering of the rule has been changed to correct this error.

13. Rule 3.4(1) Application for registration as an advisor

The rule requires an applicant for registration as an advisor to file a Form 6. The Commission has reviewed the contents of Form 6 and in the case of advisors believe additional information will be required in order to process an application. To a large extent this additional information is contained in Form 5.

Commission response

3.4(1) has been amended to require advisors to file both a Form 5 and 6.

14. Form 6 Uniform Application Form**Comment received**

One comment pointed out that there is now a new uniform application form, 1-U-2000.

Commission response

Form 6 of the rule been changed to use the new form

15. Forms 12 & 13**Comments received**

Three comments noted the form contained in the rule has now been replaced by the IDA and the Ontario Securities Commission (OSC Rule 91-502).

Commission Response

The forms should be consistent and the forms contained in the rule have been replaced.

16. Commodity Trade Manager**Comment received**

One comment suggested that the rule should contain an additional registration category beyond the dealer and advisor categories presently set out in the Act. Registrants in this proposed category would operate managed accounts through the pooling of client monies. All trading decisions would be made by the registrant.

Commission response

The rule contains registration requirements for a futures contracts portfolio managers and for an associate futures contracts portfolio managers.

In the event there is no handling of client monies the Act and rule through the advisor category provides an form of registration for the providing of advice to a customer.

The creation of an entity (such as a trust or corporation) where monies from various people are pooled for the purpose of permitting a single management of the pool would require each participant in the fund to retain an ownership in the pool equivalent the portion of that participant's contribution. This structure would most likely result in the prospectus and registration requirements of *The Securities Act* having application.

The Commission is not prepared to add a new registration category.

17. *Sub branches*

Comment received

Three comments noted the rule does not provide for sub branches.

Commission response

In preparing the rule, staff considered whether the concept of a sub branch should be included. A requirement for a sub branch concept implies that trading in contracts will be conducted through a network of offices, much in the way a registrant trading in securities may have several offices to service clients. The number of dealers expected under the Act is expected to be substantially less than the number of registrants under *The Securities Act*. The market for the trading in contracts is not the same as the market for securities. As the number of staff required for each office is small, there does not appear to the Commission to be a demand for sub branch office networks to service the requirements of the public to trade in contracts.

Subsection 3.16(4) of the rule permits the director to exempt an applicant for registration from the personnel requirements. Although this jurisdiction should be sufficient to deal with a requirement for a registrant to operate what is effectively a sub branch, staff will monitor the number and type of applications for exemption under this section to determine whether the rule should be amended to include the concept of sub branches.

18. *Directors of corporations*

Comment received

One comment suggested that rule should be expanded in several areas to include directors of corporations. This change would be consistent with IDA requirements.

Commission response

In dealing with the question of directors of a corporation that registers under the Act it was determined that there was no public interest served by requiring all directors of a corporation to be registered. In the case of large national corporations that conduct business in both securities and commodities there will be a number of directors who are not trading and are not involved in conducting trades in contracts on behalf of the corporation. It was determined that the public protection objectives of the regulatory system could be satisfied by restricting registration under the Act to those individuals that are either trading contracts on behalf of clients, or are responsible for ongoing supervision and management of the trading activities of the corporation.

In addition, the definition of responsible person in the rule includes a director in certain circumstances.

The Commission does not propose making changes to the rule as a result of this comment.

19. Section 59 Act - Prohibition on trading in non-public information

Comment received

Although outside the scope of the rule, one comment expressed the view that it was inappropriate for the Act to include a prohibition against trading using non public information. The comment stated that this prohibition is appropriate in the context of securities trading, but not in the context of the trading of contracts.

Commission response

The intention of section 59 of the Act is to make it an offence under the Act to manipulate the market price of a contract through the use of information that has not been disclosed to the market, but should have been disclosed.

In order to facilitate market transparency and efficiency it is necessary to ensure all information that should be available to market participants is in fact disclosed to the market. One market participant should not have an advantage over other participants when making trading decisions.

Disclosure of information does not extend to disclosure of trading strategies or decisions that result from the analysis of public information. As an example if a registrant develops a strategy for the trading of Canola contracts based on public information such as government agricultural reports, weather indicators and shipping information (all of which are available to the public) the strategy is not something that has to be disclosed. In a perfect market any other trader could have taken the same publicly available information and have arrived at the same (or a different) trading strategy.

In addition, a hedging strategy conducted by a market participant that is based on that's participant's needs would not normally require the participant to disclose confidential business information. A producer that has planted a crop will not be in violation of the Act for trading in contracts with a strategy based on non-public information such as the cost to that producer of planting, growing and harvesting the crop.

The Commission acknowledges further work needs to be done to define classes of trades that would not be considered in violation of the Act. Subsection 59(4) of the Act contemplates the development of regulations or rules to better define this issue.

The Commission does not propose recommending to the Government that section 59 of the Act be deleted. The section is necessary to provide the Commission with the jurisdiction to take action against attempts to manipulate the markets.

Schedule "A"
Manitoba Securities Commission Notice 2000-36
The Commodity Futures Act - Rule

List of parties that provided submissions

Anthony Denis Cattani
Benson Quinn-GMS Inc.
Investment Dealers Association (on behalf of the association)
Investment Dealers Association (on behalf of the Futures Committee)
Investors Group
Loring Ward Investment Counsel Ltd.
PCTS Inc.