

CONDUCT COMPLETED? CSA PUBLISHES THIRD DRAFT OF DERIVATIVES BUSINESS CONDUCT RULE

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After a number of years waiting, the Canadian Securities Administrators (the “**CSA**”) published a third draft of Proposed National Instrument 93-101 *Derivatives: Business Conduct* (“**Proposed NI 93-101**”) and its companion policy on January 20, 2022. This draft is open for a 60-day comment period, which is set to expire on March 21, 2022. A new draft of the companion registration rule, Proposed National Instrument 93-102 *Derivatives: Registration* (“**Proposed NI 93-102**”) has not been published yet and is not expected to be published prior to the expiry of the comment period for Proposed NI 93-101.

Key Changes to Proposed NI 93-101

We previously discussed the first draft of Proposed NI 93-101 and its companion policy during the initial period for request for comments in our [bulletin](#) from April 2017. The first draft was published on April 4, 2017 and remained open for a lengthy 150-day comment period.

A second draft was published on June 14, 2018, with one of the main changes being the introduction of the term “specified commercial hedger” in the eligible derivatives party definition. The second draft was open for a 90-day comment period, during which submissions were received from 21 commenters.

In the current draft of Proposed NI 93-101, the CSA has addressed many of the concerns raised by market participants and considered the recommendations made in the Ontario Security Commission's (the “**OSC**”) Burden Reduction Report with respect to facilitating the access of commercial entities to both local and foreign dealers to hedge their business risks.

In this publication, rather than once again describe Proposed NI 93-101 in its entirety, we will highlight the changes made from the second draft to the third draft.

Revised Definition of “Eligible Derivatives Party”

The definition of “eligible derivatives party” (“**EDP**”) has been further amended in the third draft of Proposed NI 93-101. EDP is used to separate conduct obligations, with stricter obligations applying to non-EDPs. The two major changes are:

1. Eliminating the \$10 million financial threshold in the “eligible commercial hedger” category (which replaces the “specified commercial hedger” category included in the second draft); and
2. Including a transition period to allow derivatives firms that meet certain conditions to treat existing permitted clients, accredited counterparties, qualified parties [\[1\]](#), as well as eligible contract participants under CFTC rules, as EDPs for up to five years.

Additionally, the EDP definition previously only included an investment fund “advised by an adviser registered or exempted from registration under securities legislation or under commodity futures legislation in Canada”. This has now been expanded to also include an investment fund that is “managed by a person or company registered as an investment fund manager under the securities legislation of a jurisdiction of Canada or of a foreign jurisdiction”.

Harmonizing the EDP definition more closely with the various categories used to exempt derivatives counterparties (and, in some cases, derivatives advisers) from the application of registration and disclosure obligations under provincial capital markets legislation allows derivatives dealers and derivatives advisers to better determine the specific conduct obligations that will apply to existing clients and to use existing criteria to evaluate which new clients will be EDPs.

Introduction of a Transition Period

Proposed NI 93-101 now includes a delayed effective date of one year from the date of the final publication. Given that this current draft is open for comments until March 21, 2022 and the regulators will require time to review comments and create a final draft, we anticipate that this final publication will be released between Q3 2022 and Q1 2023. With the one-year transition period, that would leave the effective date around Q3 2023 and Q1 2024. We anticipate that the final version of National Instrument 93-101 will not differ substantially from the current draft with respect to applicable conduct obligations, therefore derivatives dealers and derivatives advisers should begin taking the necessary steps to comply as soon as possible.

New Foreign Liquidity Provider Exemption for Foreign Dealers

The third draft of Proposed NI 93-101 adds a new foreign liquidity provider exemption for foreign dealers that transact with derivatives dealers in Canada. This is an outright exemption from all of the instrument's requirements and no action is required by a foreign dealer to rely on this exemption. This exemption was widely requested in the previous comments and by including it, the CSA allows Canadian dealers to have the greatest access to international pools of liquidity and hedge counterparties. It also allows foreign dealers access to Canadian dealers to hedge the Canada-related liabilities of those foreign dealers and their clients.

Revised Senior Derivatives Manager Provisions

Senior derivatives managers have certain duties such as preparing and submitting a report to the board of directors of the respective derivatives firm at least once per calendar year. These provisions no longer apply to derivatives advisers (i.e. they apply solely to derivatives dealers) and an exemption from these responsibilities is included for derivatives dealers whose aggregate outstanding gross notional amount of derivatives transactions falls below certain financial thresholds.

The threshold is \$250 million for derivatives dealers generally and \$3 billion for commodity derivative dealers dealing exclusively in commodity derivatives. “Commodity derivatives” is now a defined term, and means “a derivative that has, as its only underlying interest, a commodity other than cash, currency or a cryptoasset”. These are the same entities that are entitled to de minimus exemptions from registration under Proposed NI 93-102.

Additionally, for derivatives dealers with only a single line of derivatives business which will be registered under Proposed NI 93-102, the obligations of the senior derivatives manager are now associated with the derivatives ultimate designated person or the derivatives compliance officer, since such firms will not have a separate senior derivatives manager. It should be noted that Investment Industry Regulatory Organization of Canada (“**IIROC**”) Dealer Members are also exempted from the application of the senior derivatives manager rule as long as they comply with similar IIROC Rules.

It appears from the commentary and the amendments that the senior derivatives manager obligations are intended almost exclusively for Canadian banks so that each line of derivatives business has its own supervisor who carries out the compliance function for that line of business.

Further Guidance on Business Trigger and Schedule III Banks

In response to the comments, the commentary in the companion policy to Proposed NI 93-101 relating to the “business trigger test” has been expanded to explain how it applies to foreign dealers engaging in activities with Canadian counterparties. The “business trigger test” is used to determine if the person or company is in the business of trading or advising others with respect to over the counter derivatives.

Similarly, the companion policy now includes guidance that Schedule III banks are considered foreign dealers (despite having branches in Canada) and can rely on the foreign derivatives dealer exemption or the foreign liquidity provider exemption.

New Exemption for IIROC Dealer Members or Canadian Financial Institutions

Derivative dealers that are IIROC Dealer Members or Canadian Financial Institutions are now exempt from many provisions of Proposed NI 93-101 if they comply with their respective IIROC, *Bank Act* or OSFI requirements relating to a transaction with a derivatives party. Notably, some of the sections for which

exemptions have been granted do not currently have equivalent sections in the IIROC Rules, so it is expected that the IIROC Rules will be amended to include such sections.

A number of other significant changes have been made:

- **Short-term foreign exchange contracts in the wholesale market will be subject to certain provisions of Proposed NI 93-101:** “Short-term foreign exchange (FX) contract or instrument” is now a defined term and Proposed NI 93-101 adopts the definition used in each province's derivatives product determination rule to describe spot FX contracts. Certain provisions of Proposed NI 93-101 (fair dealing, conflicts of interest, handling complaints and compliance provisions) are now applied to spot FX contracts in the wholesale market. Proposed NI 93-101 applies to short-term FX contracts or instruments where the derivatives dealer is a Canadian financial institution and had a month-end gross notional amount under all outstanding derivatives that exceeds \$500,000,000,000. As such, this only applies to a very limited set of large derivatives dealers, namely the Canadian banks in transactions with each other and is largely meant to support the voluntary FX Code of Conduct developed by, among others, these same banks. This provision is the first regulation of the spot foreign exchange market (wholesale or otherwise) by Canadian securities regulators and it remains to be seen if further regulation will be forthcoming for other aspects of the spot FX market.
- **New Foreign Sub-Adviser Exemption :** A new foreign derivatives sub-adviser exemption has also been added that is similar to the international sub-adviser exemption in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (“ **NI 31-103** ”). This exemption allows foreign derivatives advisers to provide advice to derivatives advisers and derivatives dealers without having to comply with any business conduct requirements based on supervision by such derivatives advisers or derivatives dealers.
- **Foreign Derivatives Dealer and Foreign Derivatives Adviser Exemptions :** In addition to reformatting the exemptions in order to conform them to the structure of the exemptions in NI 31-103, Proposed NI 93-101 has populated the lists of foreign jurisdictions from which foreign dealers and foreign advisers can rely on the exemptions. The list includes most major capital markets with whom Canadian counterparties can expect to transact. Surprisingly, the list does not include Canada's North American trade partner Mexico, though the CSA has said it will consider exempting derivatives dealers and derivatives advisers from other foreign jurisdictions on a case-by-case basis.
- **Core Conduct Obligations :** The complaints handling provisions and tied selling provisions will now apply to all derivatives parties, whereas they previously only applied to transactions involving (i) non-EDPs or (ii) individual EDPs or eligible commercial hedger EDPs that did not waive the application of the provisions. The CSA has decided that these obligations are fundamental to the functioning of the

derivatives markets and should apply regardless of the sophistication of a derivatives counterparty.

Regulatory Burden Analysis

As required under the *Securities Act* (Ontario), the OSC has provided information relating to the impact of Proposed NI 93-101 on Ontario market participants (in particular on entities that will be regulated pursuant to Proposed NI 93-101). The OSC anticipates that the costs will not be substantial for IIROC Dealer Members or federally regulated financial institutions. However, the OSC's own estimates are that 70 local derivatives dealers do not fall into either category. For these "other derivatives dealers", the OSC anticipates a maximum of \$25,000 in additional costs to implement the changes required by Proposed NI 93-101 as well as about \$29,000 annually for ongoing compliance. While the OSC has not asked for comments on this analysis, entities that will be subject to Proposed NI 93-101 may want to provide information to the OSC if they believe that these estimates are incorrect, so that future regulatory burden estimates by the OSC will be more accurate.

Conclusion

The changes made to the second draft of Proposed NI 93-101 should generally be received positively by market participants (both regulated entities and business who rely on such entities to hedge their commercial risks). This demonstrates that the CSA is open to working with the market through the comment process to develop rules that protect the public while not unnecessarily harming market participants. The third draft of Proposed NI 93-101 is much closer to achieving that perfect balance, but there always remains room for improvement.

As mentioned above, the CSA has invited interested parties to submit written comments on Proposed NI 93-101 until March 21, 2022. It is likely that with the one-year effective delay, a final version of the draft may be available between Q4 2022 and Q1 2023 with an effective date no earlier than Q4 2023 or Q1 2024.

We invite market participants to discuss their questions and concerns with us and are available to assist those wishing to submit comments.

By [Shahen Mirakian](#) and [Patrick Pinho](#) (Articling Student)

[1] Permitted client is a category currently used by derivatives counterparties who rely on the international dealer exemption. Accredited counterparty is a category of counterparty to whom exemptions currently apply under the Derivatives Act (Quebec). Qualified party is a category of counterparty to whom registration and prospectus exemptions apply under various provincial rules or orders relating to over-the-counter derivatives.

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

The logo for mcmillan, featuring the word "mcmillan" in a lowercase, sans-serif font. The "m" and "c" are in a dark red color, while the "m", "i", "l", "l", "a", and "n" are in a light blue color. The logo is positioned in the upper left corner of a banner image.

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