CONDUCT CONTROLLED: CSA PROPOSES DERIVATIVES BUSINESS CONDUCT RULES

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On April 4, 2017, the Canadian Securities Administrators (the "**CSA**") published new draft rules governing the business conduct of derivatives firms. The proposed new rules opened for a 150-day comment period, which is set to expire on September 1, 2017. The new rules are encompassed in:

- Proposed National Instrument 93-101 *Derivatives: Business Conduct* (the "**Instrument**"); and
- Proposed Companion Policy 93-101 **Derivatives: Business Conduct** ("the **CP**"), and together with the Instrument, "Proposed Instrument").[1]

There are three important aspects of the Proposed Instrument:

1. The Proposed Instrument only applies to "derivatives advisers" and "derivatives dealers";
2. the Proposed Instrument creates a two-tier system, where the obligations on derivatives advisers and dealers differ depending on whether their counterpart qualifies as an "eligible derivatives party" ("**EDP**"); and
3. the Proposed Instrument largely duplicates the business conduct requirements applicable to dealers and advisers registered under securities law but introduces a new supervisory obligation for senior managers which does not exist in securities law.

Who qualifies as a "derivatives adviser" or "derivatives dealer"

Only those parties who qualify as "derivatives advisers" or "derivatives dealers" are subject to the Proposed Instrument. The two terms are defined quite broadly and generally include any person or company engaged in, or holding themselves out as engaging in, the business of advising or trading in derivatives.[2] The Proposed Instrument is therefore applicable to Canadian banks and other federally-regulated financial institutions who are active in the derivatives markets, regardless of whether they are required to be registered under securities legislation.

The CP lists factors that may be considered to determine if a person or company is in the business of trading or business of advising others as to transacting in derivatives. This is not an exhaustive list.

The factors include:

- *Quoting prices or acting as a market maker* – routinely quoting prices at which they would be willing to transact in derivatives or making a two-way market in derivatives.
- *Directly or indirectly carrying on the activity with repetition, regularity or continuity* – frequent or regular trading or advising in any way that produces, or is intended to produce, profits. The activity does not have to be their sole or even primary endeavour.
- *Facilitating or intermediating transactions* – if one provides services relating to the facilitation of trading in derivatives or acting as an intermediary (i.e. a broker).
- *Transacting with the intention of being compensated* - if one receives, or expects to receive, any form of compensation for carrying on a derivatives transaction activity. However, a person or company would not be considered to be a derivatives dealer solely by reason that it realizes a profit from changes in the market price for the derivative.
- *Directly or indirectly soliciting in relation to derivatives transactions* – contacting others to solicit derivatives transactions. Solicitation includes contacting someone by any means, including communication that offers transactions, participation in transactions or services relating to transactions, such as advertising. Solicitation involves an expectation of compensation generally (simply contacting others to obtain the best price for a hedge would not trigger the application of this factor).
- *Engaging in activities similar to a derivatives adviser or derivatives dealer* – carrying out an activity related to a derivatives transaction that would reasonably appear, to a third party, to be similar to the activities discussed above.
- *Providing derivatives clearing services* – providing services to allow third parties to clear derivatives through a clearing agency.

Generally, if the person or company regularly engages in the activities set out above in an organized manner, they would be considered a derivatives dealer or derivatives adviser. However, *ad hoc* or isolated instances of the activities above may not necessarily qualify. The factors listed above do not all carry the same weight and none of the factors will be determinative. Since the analysis of whether a person or company qualifies as a derivatives dealer or derivatives adviser is very fact-specific, it may be necessary to engage counsel to determine whether the Proposed Instrument applies to you or your business.

Who qualifies as an EDP

An EDP is an individual or organization who is considered to be sophisticated or has sufficient financial resources to purchase professional advice. Thus, they do not require the full set of protections that are afforded to retail investors.

The definition of an EDP within the Proposed Instrument includes specific types of organizations as well as tests applicable to a broad range of individuals or organizations. For example, the definition of an EDP includes Canadian financial institutions, pensions funds and different levels of government.

The general test for entities other than individuals can be summarized as:

1. that an entity represents in writing that it has enough knowledge and experience to evaluate the information about the derivatives, the suitability of the derivatives and the characteristics of the derivatives to be transacted on its behalf; and
2. that such entity has net assets of at least $25 million as shown on its most recently prepared financial statements.

For individuals, the general test can be summarized as:

1. that he or she represents in writing that he or she has enough knowledge and experience to evaluate the information about the derivatives, the suitability of the derivatives and the characteristics of the derivatives to be transacted on his or her behalf; and
2. that he or she beneficially owns financial assets[3] that have an aggregate realizable value before tax but net of any related liabilities of at least $5 million.

These general tests largely duplicate the tests in the definition of "permitted client" in National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations ("**NI 31-103**"), with changes made to make them applicable to the derivatives marketplace.

Requirements under the Proposed Instrument and the two-tier system

The Proposed Instrument imposes obligations on derivatives advisers and dealers (collectively a "**derivatives firm**") when dealing with a derivatives party. A "**derivatives party**" includes a derivative firm's customers (i.e. clients of an adviser), counterparties and other persons or companies that the derivatives firm may deal with or advise (e.g. affiliates or other derivatives firms).

The obligations within the Proposed Instrument can be divided into two tiers. First, certain obligations apply in all cases, regardless of the identity of the derivatives party. Second, certain requirements do not apply or can be waived when the derivatives firm is dealing with an EDP. Many of the requirements contained in the Proposed Instrument are similar to existing requirements that apply to dealers and advisers under securities legislation.[4]

1.Requirements that apply to all cases regardless of EDP status

The following requirements cannot be waived and apply to all derivatives dealers or advisers that are governed

by the Proposed Instrument:

- *Fair dealing* – requirements to deal fairly, honestly and in good faith (s. 8);
- *Conflicts of interest* – requirements to establish procedures to identify material conflicts of interest and respond to the conflicts (s. 9);
- *Know-your-derivatives-party* – requirements to verify the identity of a derivatives party, including verifying whether the party is an EDP or an insider of a reporting issuer, and comply with anti-money-laundering and terrorist financing obligations (s. 10);
- *Segregating assets* – requirements to segregate derivatives party assets from those assets of the derivatives firm, unless the derivatives firm is exempt[5] (s. 24, 25);
- *Confirmation of transaction* – requirement on derivatives dealer to promptly deliver a written confirmation to the derivatives party of the transaction (s. 29(1));
- *Compliance* – requirements to establish policies and procedures to assure that the firm, and individuals acting on the firm's behalf, comply with applicable laws, to manage risk and ensure that individuals have required training and expertise (s. 32);
- *Respond to material non-compliance* – requirements on derivatives firm to respond to, and report, material non-compliance in a timely manner (s. 34);
- *Recordkeeping* – requirements on creating and maintaining records (s. 36); and
- *Senior derivatives managers* – requirements on senior derivatives managers to supervise the activities conducted in their business unit, promote compliance and respond to any non-compliance (s. 33).

The senior derivatives manager supervisory obligation is not currently found in any US or European regime (though a similar obligation exists under UK rules). Senior derivatives managers are responsible for taking reactive and preventative steps to avoid material non-compliance with the Proposed Instrument with respect to all derivatives activities for which the senior manager is responsible. The senior derivatives manager must report on these obligations on at least an annual basis to the board of the derivatives firm.

The definition of a "senior derivatives manager" is "the individual designated by the derivatives firm as responsible for directing the derivatives activities of that unit". It remains to be seen how this definition will be applied in practice. Derivatives firms will need to determine what is a derivatives unit and which individual is actually responsible for directing the responsibilities of that derivatives unit.

2. Requirements that do not apply to EDPs or can be waived by an individual EDP

The following requirements either do not apply if the derivatives firm is dealing with an EDP, or can be waived by an individual that qualifies as an EDP (if an individual does not waive, then these requirements would apply). In other words, unless the investor is an EDP, these additional obligations apply:

- *Derivatives-party-specific needs and objectives* – requirements to obtain sufficient information regarding the derivative party such as the derivative party's financial circumstances and risk tolerance (s. 11);
- *Suitability* – requirements to take reasonable steps to ensure that the transaction is suitable for the derivative party (s. 12);
- *Referral arrangements* – conditions on referral arrangements and requirements to provide disclosure of fee referral arrangements to the derivatives party (s. 13, 14, 15);
  Disclosure regarding the use of borrowed money or leverage – requirement to provide the derivatives party with a written statement on the use of borrowed money (s. 16);
- *Handling complaints* – requirement to handle complaints in a fair and effective manner (s. 17);
  Tied selling - prohibition on imposing undue pressure or coercion to obtain products or services as a condition of another product or service and requirement to disclose such prohibition in writing (s. 18);
- *Fair terms and pricing* – requirements to maintain and apply written policies and procedures that are designed to obtain the most advantageous terms when acting as agent for the investor or derivative party (s. 19);
- *Disclosure to derivatives parties* – requirements to disclose certain information (s. 20-23);
- *Holding and use of derivative party assets* – requirements pertaining to holding derivative party assets in certain accounts and conditions on the use of derivative party assets (s. 26-27);
- *Investment of derivatives party assets* – requirements that the investment must be permitted and conditions if the investment is pursuant to an agreement for resale or repurchase. A loss resulting from an investment or use of a derivative party's assets by a derivative firm must be borne by the derivatives firm (s. 28);
- *Transaction confirmations* – requirement that a written confirmation of a transaction is to include certain content (s. 29(2));
- *Derivatives party statements* – requirement to deliver a monthly statement with specific information to the derivatives party in certain circumstances (s. 30).

Exemptions

There are exemptions from the requirements in the Proposed Instrument for foreign derivatives dealers and foreign derivatives advisers which are registered in the jurisdictions which appear on Appendix A of the Instrument (which is currently blank) and do not solicit business from non-EDPs. Foreign derivatives dealers and foreign derivatives advisers would have to submit to the jurisdiction of Canadian securities regulators in the same manner as parties relying on the international dealer or international adviser exemptions in NI 31-103.

There are also exemptions from the derivatives dealer business conduct requirements for Canadian banks and

registered investment dealers who comply with corresponding obligations from their prudential regulators or their self-regulatory organization as the case may be.

There is an exemption from the derivatives adviser business conduct requirements for organizations which provide general advice that does not purport to be tailored to the needs of the recipient (so long as the organization discloses any interest it may have in the underlying interest of the derivatives on which general advice is being given).

Implications

The CSA anticipates that the Proposed Instrument will increase costs resulting from compliance with the Proposed Instrument. These costs will likely be borne by the derivative firms themselves, and in certain circumstances, be passed down to the investor. However, the CSA believes that the increased costs are proportionate to the anticipated benefits such as reducing loss suffered through inappropriate transactions and market misconduct.

The Proposed Instrument could make it more difficult for foreign derivative firms to enter, or remain in, the Canadian market. To off-set this potential impact, an exemption for foreign derivative firms is contemplated if the firm is already subject to, and in compliance with, the equivalent laws of an approved foreign jurisdiction.

The 150-day comment period is a longer time-frame than what is typically provided for comments. The CSA wants to give stakeholders an opportunity to comment on both the Proposed Instrument as well as a forthcoming set of registration rules to be published as National Instrument 93-102 Derivatives: Registration (the "**Registration Instrument**"). The Registration Instrument is expected to be published in the near future. Together, the Registration Instrument with the Proposed Instrument is intended to establish a harmonized derivatives registration and business conduct regime across Canada.

Next Steps and Comments

The CSA has invited interested parties to submit written comments on the Proposal Instrument by September 1, 2017, and has specifically requested comments on 11 questions published in the Notice and Request for Comment accompanying the Proposed Instrument. The comments will be taken into consideration when drafting the forthcoming National Instrument.

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

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A Cautionary Note

[1] Ontario Securities Commission, CSA Notice and Request for Comment Proposed National Instrument 93-101 Derivatives: Business Conduct Proposed Companion Policy 93-101CP Derivatives: Business Conduct, online: http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20170404_93-101_rfc-derivatives.htm.[ps2id id='1' target='/]
[2] The term “derivatives adviser” is defined very broadly. It includes:[ps2id id='2' target='/]
(a) a person or company engaging in or holding himself, herself or itself out as engaging in the business of advising others as to transacting in derivatives, and
(b) any other person or company required to be registered as a derivatives adviser under the securities legislation of a jurisdiction in Canada.
“Derivatives dealer” means
(a) a person or company engaging in or holding himself, herself or itself out as engaging in the business of trading in derivatives as principal or agent, and
(b) any other person or company required to be registered as a derivatives dealer under the securities legislation of a jurisdiction in Canada.
[3] As defined in section 1.1 of National Instrument 45-106 *Prospectus Exemptions*.
[4] The Proposed Instrument largely duplicates the business conduct obligations of registered firms in NI 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*.[ps2id id='4' target='/]
[5] The requirement to segregate the assets does not apply to firms that comply with or are exempt from sections 3 to 8 of National Instrument 94-102 *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions* in respect of those derivatives party assets.[ps2id id='5' target='/]