PROPOSED CSA DERIVATIVES REGISTRATION RULE PART 1 – WHO MUST REGISTER

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Categories: Insights, Publications

On April 19, 2018, the Canadian Securities Administrators (the "**CSA**") published new draft rules governing the registration of derivatives market participants. The proposed rules are open for a 150-day comment period, which is set to expire on September 17, 2018. The new rules are found in:

- Proposed National Instrument 93-102 Derivatives: Registration (the "Instrument"); and
- Proposed Companion Policy 93-102 Derivatives: Registration (the "**CP**"), and together with the Instrument, "**Proposed Instrument**".[1]

The Proposed Instrument, together with Proposed National Instrument 93-101 *Derivatives*: Business Conduct and Proposed Companion Policy 93-101 *Derivatives* Business Conduct ("**NI 93-101**") published for comment in April 2017[2], are intended to implement a comprehensive regime for the regulation of persons or companies that are in the business of trading in or advising on derivatives. The CSA intends to republish NI 93-101 during the comment period for the Proposed Instrument for a second set of comments to allow interested parties to comment on the entire regulatory regime.

We are preparing two publications outlining the various requirements included in the Proposed Instrument: this bulletin focuses on who needs to register and a separate bulletin will address initial and ongoing registration requirements, including registration of individuals.

Who Must Register as a Derivatives Adviser or Derivatives Dealer

The Proposed Instrument creates four new registration categories for persons or companies active in the derivatives market:

- Derivatives dealer;
- Restricted derivatives dealer;
- Derivatives adviser; and
- Restricted derivatives adviser.

Restricted derivatives dealer and restricted derivatives advisers are persons or companies who are required to

be registered as a derivatives dealer or a derivatives adviser, as the case may be, but restrictions are placed on their ability to act in the market as a condition of their registration. For instance, a restricted derivatives dealer could be limited to only dealing in certain types of derivatives (for example, only forwards) or derivatives with certain underlyings (for example, only foreign exchange and currency derivatives). All references to derivatives dealers in this bulletin will include restricted derivatives dealers and all references to derivatives advisers will include restricted derivatives.

The requirements for registration under the legislation are being in the business of trading in derivatives for derivatives dealers and being in the business of advising others about the buying or selling of derivatives for derivatives advisers (or in either case, holding themselves out as being in the business of trading or advising, as the case may be). In certain jurisdictions, the legislated registration requirement does not include a business trigger for dealers, but the Proposed Instrument includes an explicit dealer registration exemption for parties not in the business of trading in order to create a uniform registration requirement across Canada.

In addition to the business trigger, registration as a derivatives dealer is required for any person or company who:

- transacts with, for, or on behalf of a non-eligible derivatives party;
- solicits or initiates contact with a non-eligible derivatives party to encourage that person or company to transact in a derivative or to offer a service relating to a transaction; or
- on behalf of another person or company, other than an affiliated entity, facilitates the clearing of one or more derivatives through a clearing agency or a clearing hous

The term "eligible derivatives party" was originally used in NI 93-101 and will be identical in that instrument and the Proposed Instrument. An explanation of the term is included below.

There are no additional registration triggers for derivatives advisers.

The Proposed Instrument does not include a requirement for parties with substantial aggregate derivatives exposure to register (as was discussed in CSA Consultation Paper 91-407 *Derivatives: Registration*). The CSA has said that it will be conducting additional analysis of these market participants and a future version of the Proposed Instrument may include registration requirements for them.

It should be noted that the definition of derivatives used in the Proposed Instrument is from the various derivatives product determination rules in Canadian jurisdictions and does not include exchange-traded derivatives. Registration for dealers and advisers active in exchange-traded derivatives will be governed by commodity futures legislation (for commodity futures in Ontario and Manitoba), derivatives legislation (Quebec) and securities legislation (in all other Canadian jurisdictions and for listed options in Ontario and



Manitoba).

The Proposed Instrument will not apply to certain governments, central banks, certain Crown corporations, certain international organizations and qualifying clearing agencies.

One other notable group of derivatives market participants who will not be covered by the Proposed Instrument are federally-regulated financial institutions ("**FRFIs**") in Ontario, who by virtue of the securities legislation in Ontario (which reflects the terms of the Hockin-Kwinter intergovernmental agreement between the governments of Ontario and Canada), are exempt from Ontario registration requirements. In practice, this lack of inclusion will not have a major effect because FRFIs will be subject to registration requirements in all other Canadian jurisdictions. It remains to be seen if FRFIs will argue, as many do in respect of securities dealer or adviser registration requirements, that this legislation is not within the power of the provinces with respect to them due to the separation of powers set out in the Canadian constitution.

Indicia for "Being in the Business" for Derivatives Dealers and Derivatives Advisers

Derivatives Dealers

The factors that indicate that a person or company is in the business of trading in derivatives are set out in the CP as:

- Market making (which is basically activity where a party is not concerned about the nature of the positions they take, but instead are compensated by the act of intermediation through spreads or fees);
- Transacting with frequency or regularity;
- Facilitation and intermediation;
- Transacting with the intention of being compensated;
- Soliciting transactions; or
- Engaging in activities similar to a derivatives dealer.

These indicia are essentially the same as those in section 1.3 of the Companion Policy to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103**") for securities dealers (market making and intermediation are treated as a single category in NI 31-103), so the CSA already has experience in interpreting these indicia.

Derivatives Advisers

Rather than set out specific indicia, the CP sets out a number of examples where registration would be required (absent an exemption) while the notice and request for comment accompanying the Proposed Instrument discusses certain circumstances where a registration requirement would not be triggered.

The CP includes a number of examples to demonstrate when registration is required. Generally, these are instances where a registrant under securities or commodity futures legislation also provides advice on derivatives or derivatives strategies, with the exception of one scenario that is very specific to the derivatives marketplace: "a person or company that recommends a derivative or derivatives trading strategy to investors as part of a general solicitation by an online derivatives trading platform."

This specific example is likely included to require registration as derivatives advisers for companies who provide free advice or information about market trends (generally by email or through social media) and then direct the recipients of the information to transact on a particular online platform (usually for instruments like contracts for differences or rolling spot foreign exchange transactions). There has been a proliferation of these activities in the Canadian market recently by foreign companies, and by specifically mentioning these activities in the CP, the CSA is warning foreign companies that they must not solicit Canadians without being regulated.

The notice and request for comment accompanying the Proposed Instrument note that securities or commodity futures registrants and professionals (i.e. lawyers, accountants, geologists, etc.) who advise on derivatives in a way that is incidental to their core activities will not be considered to be in the business of advising others with regards to derivatives. The term "incidental" is not defined in the notice or the Proposed Instrument. Past commentary from the CSA suggests that the activity cannot be a source of income and the activity should be a very small part of the overall activities of the registrant for any one client. A similar concept in Ontario commodity futures legislation regarding securities advisors who advise on commodity futures has been the subject of much debate and discussion for over 25 years, so it is unlikely that the true scope what is incidental activity will be determined in any definitive fashion before the Proposed Instrument comes into force.

Types of Derivatives Dealers

Derivatives dealers are divided into two broad types in the Proposed Instrument: those who deal solely with eligible derivatives parties and those who deal with both eligible derivatives parties and non-eligible derivatives parties.

Derivatives dealers who do not deal solely with eligible derivatives parties are required to become IIROC Dealer Members. It remains to be seen if IIROC will impose different requirements on firms seeking to become IIROC Dealer Members only in respect of their derivatives activities. Thus far, firms that have become IIROC Dealer Members solely due to their trading of foreign exchange contracts or contracts for differences have had to comply with the same regime as all other firms.

Eligible derivatives parties

An eligible derivatives party is defined essentially the same as a "permitted client" in NI 31-103 or as a "qualified party" in the existing provincial registration exemptions for over-the-counter derivatives dealing. The same general list of government entities, financial institutions and registrants is included in all of the above documents (with the exception being that a registered charity is not included in the eligible derivatives party definition) and the asset tests are also similar (\$25 million in net assets as shown in the most recently prepared financial statements for persons and companies other than individuals and \$5 million in net financial assets for individuals).

The definitions differ in that the eligible derivatives party definition includes commercial hedgers (unlike the permitted client definition) who have net assets of at least \$10 million or are guaranteed by an eligible derivatives party (unlike the qualified party definition). Commercial hedger is defined broadly and includes all hedging related to any business activities (not just limited to commodities). It should be noted that there was no commercial hedger category in the definition of eligible derivatives party published in NI 93-101 and its inclusion here (and therefore in the next draft of NI 93-101) is in direct response to comments received on that instrument.

Parties can rely on written representations from their counterparties to determine eligible derivatives party status, only where it would be reasonable to do so.

Exemptions from Registration Requirements

Derivatives Dealers

- End Users this is not so much an exemption as a limitation on who is considered an end-user. The end-user exemption basically codifies the business trigger indicia for derivatives dealers and advisers, but limits it to parties who are not registered in any jurisdiction in respect of dealing or advising activities. The effect of this is that foreign banks or dealers who only deal with Canadian counterparties to hedge obligations would be required to register absent some other exemption. This outcome is likely not ideal as many foreign banks only deal with Canadian counterparties to hedge Canada-related risks (such as Canadian currency) and Canadian counterparties are best placed worldwide to manage such risks. However many of these foreign banks will not want to comply with Canadian registration requirements, so they will seek to hedge risks with less well-placed parties, thus likely increasing overall systemic risk.
- Small players parties who are not registered anywhere and limit their activities to eligible derivatives parties are not required to register if they have do not have a month-end aggregate gross notional amount greater than \$250,000,000 at any time over the previous 24 months. For foreign parties, this is measured only with respect to their transactions with Canadian counterparties. The term "notional amount" is used throughout the Proposed Instrument and there are a number of questions from the

CSA on how it should be interpreted particularly for complex transactions and transactions where there isn't a money amount referenced. Whatever definition is used by the CSA, it will be broadly consistent with the international consensus.

- Commodity dealers with less than \$1 billion notional parties who deal solely in commodities (which do not include currencies, cryptocurrencies or securities), are not registered anywhere, and limit their activities to eligible derivatives parties are not required to register if they have do not have a month-end aggregate gross notional amount greater than \$1,000,000,000 at any time over the previous 24 months of derivatives with commodities as their only underlying asset. For foreign parties, this is measured only with respect to their transactions with Canadian counterparties.
- Affiliated entities parties whose derivatives activities are limited to trading with affiliated entities (other than investment funds) are not required to register.
- Foreign derivatives dealers parties with a head office or principal place of business in a foreign jurisdiction specified in Appendix B of the Proposed Instrument (which is currently blank) and limit their activities in Canada to eligible derivatives parties are not required to register. This exemption broadly corresponds to the international dealer exemption in NI 31-103 (without the requirement that the derivatives themselves be foreign).

Derivatives Advisers

- Advising generally parties who deliver advice that is not tailored to the needs of the specific recipient and disclose all financial interests in recommended derivatives or their underlyings are not required to register.
- Foreign derivatives advisers parties with a head office or principal place of business in a foreign
 jurisdiction listed in Appendix G (which is currently blank) and limit their activities in Canada to eligible
 derivatives parties are not required to register. This exemption broadly corresponds to the international
 adviser exemption in NI 31-103; however, it does not limit the percentage of revenue that can be derived
 from Canadian clients or require that the derivatives be foreign.

The Proposed Instrument does not include an exemption which corresponds to the international sub-advisor exemption in NI 31-103 (which allows for foreign advisers to provide advice through a written agreement with a Canadian registered adviser or dealer).

Substituted Compliance

Certain parties that are already regulated may rely on compliance with the requirements applicable to them under other regulatory regimes to avoid compliance with certain obligations of the Proposed Instrument. These entities would still need to register, but they would not be subject to additional compliance requirements.

The entities that may use substituted compliance are:IIROC Dealer Members, various federally (OSFI) and provincially regulated financial institutions, foreign dealers who deal with non-eligible derivatives parties and foreign advisors who deal with non-eligible derivatives parties.Other than OSFI and AMF regulated financial institutions, there is not yet any analysis of which obligations could be avoided by substituted compliance.For OSFI and AMF regulated financial institutions, the Proposed Instrument includes an annex setting out which obligations have equivalents in the OSFI and AMF regulations and, therefore, would be subject to substituted compliance.

The Proposed Instrument includes substituted compliance for registered advisers (securities or commodity futures) but the accompanying notice and request for comment asks if substituted compliance should be extended to these entities as well.

Next Steps

The CSA has solicited comments from interested parties on the Proposed Instrument by **September 17, 2018**. It has specifically requested feedback on 12 questions published in the notice and request for comment which accompanies the Proposed Instrument.

We invite market participants who wish to discuss registration obligations for firms to contact us with any questions or concerns. Market participants may wish to wait to review our second bulletin on initial and ongoing registration requirements and for the republication of NI 93-101 before making any comments to the CSA. We are available to assist any parties interested in commenting.

by Shahen Mirakian and Shannon Ste. Marie, Student at Law

 Ontario Securities Commission, CSA Notice and Request for Comment Proposed National Instrument 93-102 Derivates: Registration Proposed Companion Policy 93-102 Derivatives: Registration, online: <u>http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20180419_93-102_rfc-derivatives-registration.htm.</u>
 Please refer to McMillan LLP Derivatives Law bulletin on the proposed rules governing the business conduct of derivatives firms <u>here</u>.

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.

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