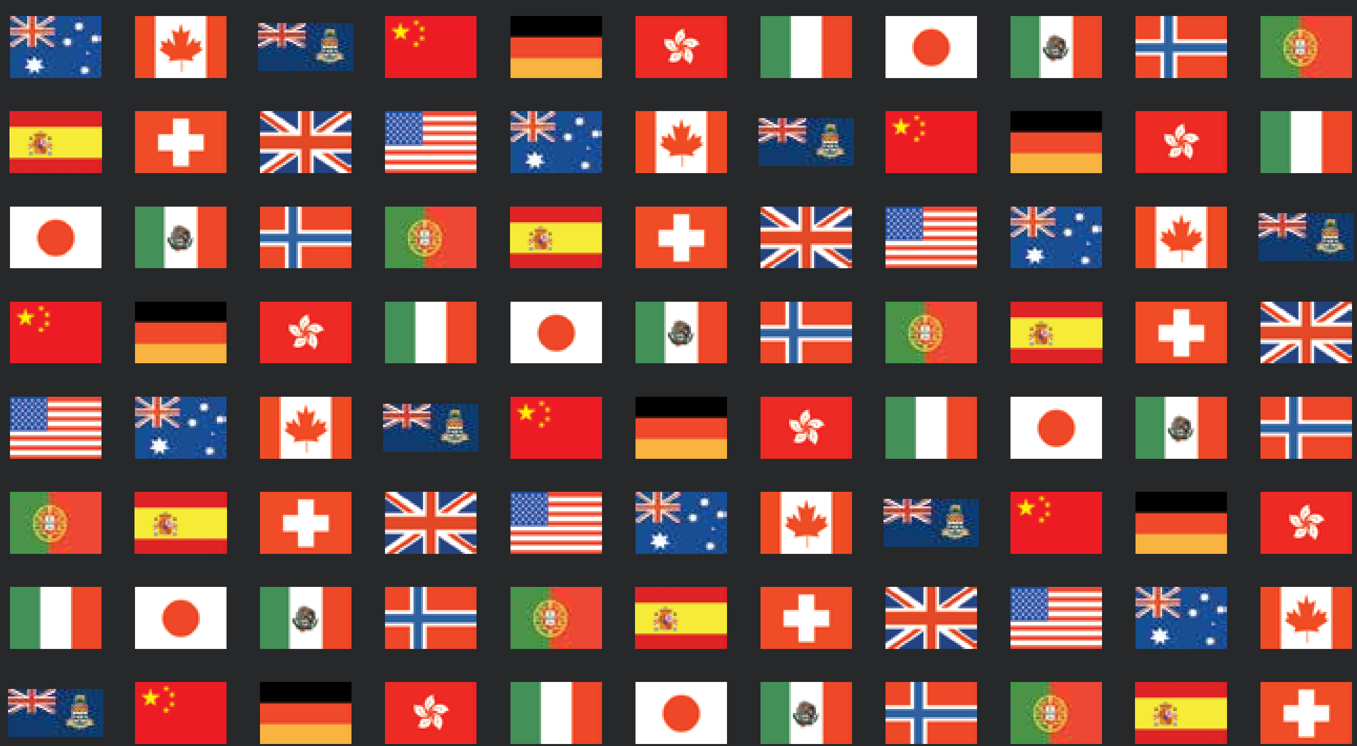
Equity Derivatives

Contributing editors

John M Brandow, Ray Ibrahim and Mark M Mendez



2018

GETTING THE DEAL THROUGH

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DEAL THROUGH

Equity Derivatives 2018

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Published by
Law Business Research Ltd
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London, W11 1QQ, UK
Tel: +44 20 3780 4147
Fax: +44 20 7229 6910

First published 2016
Third edition
ISBN 978-1-78915-021-6

Printed and distributed by
Encompass Print Solutions
Tel: 0844 2480 112

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Third edition

Getting the Deal Through is delighted to publish the third edition of *Equity Derivatives*, which is available in print, as an e-book and online at www.gettingthedealthrough.com.

Getting the Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique **Getting the Deal Through** format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes a new chapter on Australia.

Getting the Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.gettingthedealthrough.com.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editors, John M Brandow, Ray Ibrahim and Mark M Mendez of Davis Polk & Wardwell LLP for their continued assistance with this volume.

GETTING THE
DEAL THROUGH

London
March 2018

Canada

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1 Other than transactions between dealers, what are the most typical types of over-the-counter (OTC) equity derivatives transactions and what are the common uses of these transactions?

OTC equity derivatives in Canada are typically used to hedge or monetise equity positions or to obtain synthetic economic exposures. Examples include collars and prepaid forwards to hedge or monetise shareholdings, margin loans to finance or lever large shareholdings, swaps to hedge issuers' obligations under employee benefit plans and total return swaps (TRS) in respect of single names or baskets of securities. The use of more complex structures, including accelerated share repurchase (ASR) transactions, which are relatively common in the United States, has been inhibited by restrictions in Canada on the ability of issuers to repurchase their own shares and the absence of exemptive relief comparable to the no-action letters issued by the US Securities and Exchange Commission in respect of transactions involving shares subject to resale restrictions. Foreign dealers are active in the Canadian market.

2 May market participants borrow shares and sell them short in the local market? If so, what rules govern short selling?

There is no general prohibition on market participants borrowing and selling shares short in the Canadian market. Generally, under applicable securities laws, where an order for the sale of a security is placed through a registered dealer by a person who does not own the security (or its agent knows that the person does not own the security), a declaration of the short sale is required.

Trading on marketplaces in Canada is governed by the Universal Market Integrity Rules (UMIR) that are administered by the Investment Industry Regulatory Organization of Canada (IIROC) and apply to IIROC participants (ie, generally, registered domestic dealers). The UMIR require identification of short sales as such and prohibit short sales of any IIROC-designated 'short sale ineligible security'. The UMIR also require any market participant who enters an order that would be a short sale of an IIROC-designated 'pre-borrow security' to have made arrangements to borrow the securities necessary for settlement prior to the entry of the order on the marketplace.

Certain federal laws (such as the Canada Business Corporations Act and the Bank Act) prohibit insiders of distributing corporations (generally, public corporations) subject to those Acts, from knowingly selling securities they do not own or have not fully paid for, subject to certain exemptions. Insiders for these purposes include persons employed or retained by the corporation. The potential application of these provisions to short sale hedging by a dealer in respect of derivative transactions over such an issuer's securities may need to be assessed if the dealer has other business dealings with the issuer.

3 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between dealers. What regulatory authorities are primarily responsible for administering those rules?

The laws and regulations applicable both to domestic and to foreign dealers in OTC equity derivatives in Canada are a patchwork and their application depends upon the jurisdictions and types of entity concerned.

Aspects of OTC derivatives trading are governed by Canadian federal laws as well as the securities laws of the 13 separate provincial (and territorial) governments. The primary laws are the provincial securities laws, and uniquely in Quebec, the Derivatives Act, administered by the securities regulatory authorities of each province or territory; for example, the Ontario Securities Commission (OSC) and the financial markets regulator (AMF) in Quebec. These can be specific to a province or territory or take the form of national or multilateral instruments adopted by one or more members of the Canadian Securities Administrators (CSA), an umbrella body of all the provincial securities regulators. Regulation is generally harmonised but local variations do exist.

Efforts are currently under way to establish a cooperative capital markets regulatory authority (CMRA) between the federal government and those provincial and territorial governments that agree to cooperate in this system. The CMRA will be responsible for administering a proposed uniform Capital Markets Act that will replace the existing securities legislation in each cooperating province or territory and regulate, among other things, derivatives trading and a proposed federal Capital Markets Stability Act that will address systemic risk.

In addition, domestic investment dealers are subject to the Dealer Member Rules of IIROC and UMIR. Stock exchanges and other marketplaces also impose their own rules, such as those applicable to trading of listed securities on the Toronto Stock Exchange (TSX) and to trading of equity options listed on the Montreal Exchange (MX).

Federally regulated financial institutions, including Canadian banks, are subject to their own governing statutes (eg, the Bank Act) and are required to comply with various principles-based guidelines of the Office of the Superintendent of Financial Institutions (OSFI) relating to derivatives trading such as Guideline B-7 Derivatives Sound Practices.

Foreign dealers engaging in OTC equity derivatives transactions with Canadian counterparties may be affected by the above legislation (eg, restrictions under the Bank Act on foreign banks conducting a banking business in Canada and dealer registration requirements).

4 In addition to dealers, what types of entities may enter into OTC equity derivatives transactions?

There are no general restrictions on non-dealer entities entering into OTC equity derivatives transactions; however, dealers may face restrictions on the categories of non-dealer entities they can transact with. For example, under the securities laws of some provinces, engaging in transactions with entities located in those provinces could give rise to prospectus and dealer registration requirements, either because OTC equity derivatives are characterised as securities or because they are separately regulated as derivatives. In Quebec, derivatives dealers are subject to registration requirements under that province's Derivatives Act. There are, however, broad exemptions where the dealer registration requirements apply when both parties to the transaction are 'qualified parties', or in Quebec, 'accredited counterparties'. In Ontario, securities dealer registration requirements generally do not apply in the context of OTC derivatives transactions entered into among sophisticated institutional parties.

In addition, in jurisdictions where certain types of OTC derivatives are characterised as securities (eg, physically settled options on securities), foreign dealers who rely upon the registration exemption for international dealers under National Instrument 31-103 (NI 31-103) are generally required to limit their trading activities to 'permitted clients' as defined in NI 31-103, and are subject to certain restrictions on their ability to trade equity securities of Canadian issuers.

In the first part of 2018, the CSA intends to publish proposed rules for the registration of derivatives dealers in all Canadian jurisdictions (other than Quebec, which already has a registration regime). As in Quebec, it is anticipated that exemptions from these registration requirements will be available to derivatives dealers who restrict their activities to prescribed categories of sophisticated counterparties but it remains to be seen exactly what form this registration regime will take.

5 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer? What regulatory authorities are primarily responsible for administering those rules?

In addition to the laws and regulations referred to in questions 3 and 4, certain laws and regulations may affect the ability of certain types of counterparties to engage in transactions with dealers. For example, corporate laws at the federal level, such as the Canada Business Corporations Act and the Bank Act, restrict insiders' short selling of, and purchases or sales of transferable puts and calls on, the securities of corporations subject to those Acts, and public mutual funds are limited under National Instrument 81-102 Investment Funds to engaging in derivatives transactions that meet certain minimum ratings requirements or with counterparties that meet such requirements.

6 Do securities registration issues arise if the issuer of the underlying shares or an affiliate of the issuer sells the issuer's shares via an OTC equity derivative?

Under applicable provincial securities laws, a 'distribution' of securities requires the issuer or seller to file and obtain a receipt for a prospectus (the 'prospectus requirement') unless the distribution can be made pursuant to a prospectus exemption. A 'distribution' includes the issuance and sale of previously unissued securities as well as the sale of securities from the holdings of a 'control person', being generally a person or group of persons who own or control 20 per cent or more of the outstanding voting securities. Physical settlement of OTC equity derivatives may therefore be subject to the prospectus requirement, or require a prospectus exemption, if it would constitute a distribution of such securities. Securities distributed pursuant to prospectus exemptions are subject to a number of other requirements, including compliance with the prospectus exemption itself, compliance with applicable stock exchange rules and post-trade reporting to the applicable securities regulator. They may also be subject to hold periods, restricting any further trades in the securities for four months and one day from the date of the original distribution, unless a further prospectus exemption can be relied upon. In circumstances where entry into an OTC equity derivative can itself be seen as a distribution of a security pursuant to a prospectus exemption, tacking may permit the hold period otherwise applicable to securities issued on physical settlement of the derivative to be reduced or eliminated.

The treatment in Canada of hedging activities in respect of an OTC equity derivative where the dealer sells borrowed shares in the market to hedge its obligations is uncertain. There is no specific guidance in Canada that would deem the sales of such borrowed shares to require a prospectus (or deeming to be freely tradeable shares ultimately issued by the issuer or sold by the control person pursuant to the derivative). While, under Canadian rules, the sale of borrowed shares (which are freely tradeable) would not on its own constitute a distribution, there is a risk that sales in these circumstances could be characterised as indirect distributions under the broad definition of that term under Canadian securities laws, which includes a 'sale and a resale in the course of a distribution'. These concerns may be reduced if the derivative transaction is exclusively cash-settled.

7 May issuers repurchase their shares directly or via a derivative?

An issuer's repurchase of its own securities (either directly in the market or on physical settlement of an OTC derivative) would generally constitute an 'issuer bid' and require compliance with applicable formal issuer bid rules or an exemption therefrom, including an exemption for bids made through and pursuant to the rules of an applicable recognised stock exchange (such as the TSX).

The TSX's normal course issuer bid (NCIB) rules impose annual and other volume restrictions and generally prohibit private agreement repurchases. There are no express TSX rules governing ASR or similar transactions between dealers and issuers (although such rules in respect of ASRs and physically settled derivatives were proposed by the TSX in 2004 but never implemented). The regulators have developed internal guidelines relating to such transactions and are willing to consider them for exemptive relief on a case-by-case basis.

As the NCIB rules do not readily accommodate physical settlement of OTC equity derivatives, transactions where the issuer is long its own shares are typically cash-settled. To address concerns that the dealer might be characterised as acting as an agent for the issuer, transaction documents are typically drafted to give the dealer wide discretion in its hedging activities. In cases where the issuer finances or exercises control over the dealer's hedging activities, exemption orders confirming that such activities do not constitute an issuer bid have been obtained.

Both the UMIR and the securities laws prohibit market manipulation, which includes any activity that results in or contributes to a misleading appearance of trading activity in, or an artificial price for, a security or derivative of a security. Market manipulation is broadly construed and can include artificially raising, lowering or maintaining prices, entering orders without the intention of settlement and engaging in manipulative trading activity designed to increase the value of a derivative position.

Corporate laws in Canada also require compliance with applicable solvency requirements where the issuer acquires its own shares.

8 What types of risks do dealers face in the event of a bankruptcy or insolvency of the counterparty? Do any special bankruptcy or insolvency rules apply if the counterparty is the issuer or an affiliate of the issuer?

Depending on the type of transaction, there would be a risk of court-imposed stays on acceleration or termination and a compromise of claims. However, if the transaction can be characterised as an eligible financial contract (EFC), termination and netting rights, and a secured party's ability to realise on financial collateral for EFCs, are generally protected. The Payment Clearing and Settlement Act (Canada) also protects netting agreements between financial institutions (as defined). An exception to these protections exists if the insolvent counterparty is subject to the Canada Deposit Insurance Corporation Act (CDIC Act), which provides for a potential one-day stay of termination of all EFCs pending a decision as to whether to transfer the EFC and related financial collateral to a bridge institution and, if the transfer occurs, a permanent stay on terminating the EFC by reason of the counterparty's insolvency. The CDIC Act has been amended recently to also provide for a further stay to permit implementation of certain restructuring measures in respect of an insolvent deposit-taking institution.

There is a risk that claims against an insolvent issuer on the termination of an equity derivative over the issuer's shares might be characterised as 'equity claims' under Canadian insolvency law and subordinated to other debt claims against the issuer. Canadian law in this area is not well-developed but good arguments can be made that such claims should not be deemed equity claims.

9 What types of reporting obligations does an issuer or a shareholder face when entering into an OTC equity derivatives transaction on the issuer's shares?

OTC equity derivatives entered into by 'insiders' are subject to insider and early warning reporting rules. However, certain exemptions apply to prescribed eligible institutional investors and pledgees.

Insider reporting rules require 'reporting insiders' to disclose their direct or indirect beneficial ownership, control or direction over securities of the reporting issuer, and any interest in, or right or obligation associated with, a 'related financial instrument' involving a security of the reporting issuer. Agreements that alter the reporting insider's 'economic exposure' to the reporting issuer are also disclosable. Reporting insiders can include directors or officers of a reporting issuer, as well as significant shareholders and the issuer itself.

Any person or company that acquires beneficial ownership or the power to exercise control or direction (ie, the ability to exercise the 'attributes of ownership') over voting or equity securities of any class of a reporting issuer that, together with such offeror's securities of that class, would constitute 10 per cent or more of the outstanding securities of that class must make disclosure in accordance with applicable early warning reporting rules, which includes the issuance of a press release and an early warning report. The 10 per cent threshold is reduced to 5 per cent where a formal takeover bid has been made for the securities of the subject reporting issuer. A further press release and early warning report are required where there is any change in a material fact in a previously filed report, or where an additional 2 per cent of the outstanding securities of the class is acquired. Disclosure of 2 per cent decreases in ownership and exit reports where ownership falls below the 10 per cent threshold are also now required.

With respect to derivatives specifically, the regulators have noted that the use of derivatives such as swaps to 'park securities' in a deliberate effort to avoid reporting or takeover bid obligations could constitute abusive conduct. While the regulators originally proposed to include 'equity equivalent derivatives ' for the purposes of determining whether an early warning reporting requirement is triggered, commenters raised concerns that doing so would complicate the early warning regime and create a compliance burden, without providing any real benefit to the investing community. This original proposal was abandoned but the regulators provided guidance regarding certain derivative arrangements (such as equity swaps) that may be captured under the early warning system. Specifically, guidance has been added to National Policy 62-203 Take-Over Bids and Issuer Bids noting that where an investor has the ability to, formally or informally, obtain the voting or equity securities or to direct the voting of voting securities held by any counterparties to the transaction, an investor may be deemed to have beneficial ownership, control or direction, over the referenced voting or equity securities.

Further acquisitions of securities of the class in respect of which the early warning report is to be made are prohibited during the period commencing with the event giving rise to the filing requirement and terminating one business day after the report is filed. This moratorium may impact upon the ability of a dealer to engage in hedging activity if the dealer itself is the entity subject to the early warning reporting requirements.

Early warning reporting includes disclosure regarding the number, amount and price of the securities acquired, the purpose of the offeror and any joint actors in effecting the transaction, the general nature and the material terms of any agreement with respect to securities of the reporting issuer entered into by the offeror, or any joint actor, and the names of any joint actors. The amendments referred to above will also require additional disclosure regarding the material terms of related financial instruments, securities lending arrangements and other agreements, arrangements or understandings involving the subject securities.

All of the provinces and territories of Canada have implemented derivatives data reporting requirements for OTC equity derivatives transactions if one or both of the parties is a 'local counterparty' in one or more of these jurisdictions. Additional reporting obligations with respect to physically settled OTC equity derivatives are discussed in question 6.

10 Are counterparties restricted from entering into OTC equity derivatives transactions during certain periods? What other rules apply to OTC equity derivatives transactions that address insider trading?

Under applicable securities laws, persons in a 'special relationship' with a public issuer are prohibited from purchasing or selling securities of the issuer with knowledge of a 'material fact' or a 'material change' with respect to the issuer that has not been generally disclosed. The prohibition extends to puts, calls, options or any other right or obligation to purchase or sell securities of the issuer, the market price of which varies materially with the market price of the securities of the issuer or a related derivative. Under the Securities Act (Ontario), a 'related derivative' means, with respect to a security, a derivative that is related to the security because the derivative's market price, value, delivery obligations, payment obligations or settlement obligations are, in a material way, derived from, referenced to or based on the market price, value, delivery obligations, payment obligations or settlement obligations of the security. Thus, a person that is in a special relationship with an issuer could be prohibited from entering into, or performing its obligations under, an OTC equity derivatives transaction or engaging in hedging in respect of that issuer's securities when it has material non-public information with respect to the issuer. Hedging by a dealer may also be affected by an issuer's compliance with its timely disclosure obligations if entry into the related derivatives transaction could itself constitute material non-public information about the issuer.

A person in a 'special relationship' with the issuer includes a person or company who is an insider, affiliate or associate of the issuer as well as certain others, such as those proposing to make a takeover bid for the securities of the issuer, as well as those engaged in any business or professional activity with or on behalf of the issuer. The prohibition can also extend to persons (tippees) who learn of material undisclosed information from someone that is in a special relationship with the issuer.

11 What additional legal issues arise if a counterparty to an OTC equity derivatives transaction is the issuer of the underlying shares or an affiliate of the issuer?

The relevant issues are outlined in the responses to questions 6, 7, 9 and 10.

12 What types of taxation issues arise in issuer OTC equity derivatives transactions and third-party OTC equity derivatives transactions?

The Income Tax Act (ITA) does not contain a regime that specifically governs the taxation of equity derivatives transactions. Rather, income tax is imposed in accordance with general rules in the ITA together with common law principles developed by the courts. Administrative pronouncements published by the Canada Revenue Agency (CRA) also provide guidance.

Payments received (or made) pursuant to an equity derivatives transaction are, subject to the application of a particular set of rules in the ITA, generally characterised as a contractual payment giving rise to ordinary income (or a deduction from income), although case law does provide for capital treatment in cases where the derivatives are used to hedge a taxpayer's exposure in connection with a capital asset or transaction. Recent amendments to the ITA enable Canadian taxpayers (even if not a financial institution) to elect to use mark-to-market principles when reporting their income and losses associated with certain types of derivatives not held on capital account. Derivatives held by Canadian taxpayers on capital account are generally required to report their related gains and losses on a realisation basis.

In some tax-motivated transactions involving the use of equity derivatives, the CRA may attempt to deny certain tax advantages realised by asserting that a taxpayer, other than the holder of the underlying securities, is the beneficial owner of the securities for income tax purposes by virtue of its economic rights under the equity derivative (eg, the total return recipient under a TRS). The ITA also includes a general anti-avoidance rule introduced to minimise abusive tax avoidance.

The ITA contains several sets of rules to deal with specific issues that can potentially be relevant to the income tax treatment of equity derivatives (or a related transaction). These include rules that:

- address the treatment of premiums paid and received on options held on capital account;
- provide for deemed ownership of securities and the character of compensation payments under securities lending arrangements, including absolute transfer collateral arrangements;
- prevent taxpayers from claiming two deductions in respect of one cash outflow under dividend rental arrangements;
- address synthetic equity arrangements used to avoid the dividend rental rules referred to in the previous point;
- deem the taxpayer to have disposed of the underlying asset for its fair market value under synthetic disposition arrangements;
- shut down investment structures that use derivative forward agreements designed to convert fully taxable ordinary income into capital gains income; and
- defer the recognition of a loss (or a portion of a loss) otherwise realised by a taxpayer on the disposition of a property (other than capital property but including liabilities and other obligations that are not capital in nature) that was a position in a particular straddle transaction until the taxation year in which the taxpayer disposes of the related offsetting position.

These rules are complex and specific advice should be obtained regarding their potential application to particular transactions.

13 Describe the liability regime related to OTC equity derivatives transactions. What transaction participants are subject to liability?

Non-compliance with provincial securities legislation is subject to enforcement by securities regulators. This includes potential liability for non-compliance with prospectus requirements or exemptions (such as filing of post-trade reports and proper reliance on prospectus exemptions). Prospectuses or offering memoranda are also subject to statutory liability for misrepresentations. Dealers or other intermediaries are subject to enforcement for non-compliance with dealer registration requirements. Further, any person or company subject to reporting or other obligations, such as insider reporting or early warning reporting in the case of an investor or counterparty, is also subject to enforcement for non-compliance and to liability for losses incurred by third parties for insider trading. Reporting issuers are subject to similar liability and enforcement, including for non-compliance with continuous and timely disclosure obligations, as well as secondary market civil liability for misrepresentations in public documents or public oral statements or failure to make timely disclosure of material changes.

Officers and directors who authorise, permit or acquiesce in the commission of any offence may also be liable regardless of whether a charge has been laid or a finding of guilt has been made against their company. In addition to contravention of specific provisions of securities laws, it is also an offence to make misrepresentations in various types of documents required to be filed or furnished. General offence provisions of provincial securities laws also prohibit engaging in 'fraud and market manipulation' and in making 'misleading or untrue statements'. Further, the securities regulators have broad jurisdiction to make and to apply to the courts for certain orders where the conduct engages their public interest jurisdiction.

14 What stock exchange filings must be made in connection with OTC equity derivatives transactions?

If the OTC equity derivative transaction involves an issuance of listed securities, the issuer will need to comply with applicable TSX listing requirements, including those relating to private placements. If the OTC equity derivative transaction forms part of an NCIB, the issuer will need to comply with NCIB disclosure and filing requirements.

15 What types of documents are typical in an OTC equity derivatives transaction?

This will depend on the circumstances, but most OTC equity transactions are documented with a confirmation under an International Swaps and Derivatives Association (ISDA) Master Agreement and credit support arrangements are documented under an ISDA Credit Support Annex. Stock borrowing arrangements are typically documented under one of the industry standard securities loan agreements. For margin loans, parties typically use bespoke documentation (eg, loan and pledge agreements).

16 For what types of OTC equity derivatives transactions are legal opinions typically given?

They would generally not be requested or given in inter-dealer transactions. They would be more common in cases where there could be a question about the capacity and authority of a non-dealer counterparty to engage in the transaction.

17 May an issuer lend its shares or enter into a repurchase transaction with respect to its shares to support hedging activities by third parties in the issuer's shares?

As a practical matter, no. The lending by and redelivery of shares to a lender are generally regarded for securities laws purposes as a disposition to and acquisition from the borrower of the relevant securities by the lender. Therefore, the considerations discussed under question 6 relating to the sale by an issuer of its own securities, and under question 7 relating to the repurchase by an issuer of its own securities, would be applicable. If the lender is a control person, the considerations referred to in the responses to those questions should also be taken into account. Among other things, the imposition of hold periods would likely restrict the ability of the borrower to freely resell the shares or deliver them to close out open borrow positions and the redelivery of shares to the issuer would trigger issuer bid requirements.

18 What securities registration or other issues arise if a borrower pledges restricted or controlling shareholdings to secure a margin loan or a collar loan?

As discussed in question 6, under Canadian securities laws any 'trade' that is a distribution must be made in compliance with the prospectus requirement or pursuant to a prospectus exemption. The definition of 'trade' under the Securities Act (Ontario), by way of example, includes 'any sale or disposition of a security for valuable consideration' but does not include a transfer, pledge or encumbrance of securities for the purpose of giving collateral for a debt made in good faith, other than a transfer, pledge or encumbrance of securities of an issuer from the holdings of a control person.

Generally, a pledge by someone who is not a control person would not be a distribution. However, if the securities subject to the pledge were acquired by the borrower under a prospectus exemption, they may be subject to a hold period, and require a prospectus or reliance on a further prospectus exemption to effect the disposition.

A pledge by a control person would generally be considered a distribution; however, a prospectus exemption is available for any distribution of a security to a lender or other encumbrancer from the holdings of a control person for the purpose of giving collateral for a bona fide debt of the control person. A prospectus exemption allows for a distribution by a lender or other encumbrancer for the purpose of liquidating a debt made in good faith by selling or offering for sale the pledged security, if the security was acquired in a control distribution, subject to certain conditions. This exemption permits the lender to freely sell the securities subject to the pledge in the market if a prescribed seven-day public notice is provided and certain other conditions are satisfied, including:

- that the issuer is a reporting issuer;
- the pledgee, if the distribution is for the purpose of liquidating a debt, has held the securities for at least four months;
- no extraordinary commission is paid in respect of the trade; and
- the selling security holder has no reasonable grounds to believe that the issuer is in default of securities legislation.

Alternatively, the securities may be sold off-market in reliance on another prospectus exemption (eg, trades to 'accredited investors') but these will likely trigger further hold periods.

19 If a borrower in a margin loan files for bankruptcy protection, can the lender seize and sell the pledged shares without interference from the bankruptcy court or any other creditors of the borrower? If not, what techniques are used to reduce the lender's risk that the borrower will file for bankruptcy or to prevent the bankruptcy court from staying enforcement of the lender's remedies?

Margin loans are one of the enumerated categories of eligible financial contracts (EFCs) in respect of which termination and netting rights, as well as a secured lender's ability to deal with financial collateral such as pledged shares, are protected from stays on enforcement under Canadian insolvency legislation. The EFC definition appearing in such legislation refers to a 'margin loan in so far as it is in respect of a securities account … maintained by a financial intermediary'. The term 'financial intermediary' includes brokers, banks or trust companies that in the ordinary course of business maintain securities accounts for others. The classic example of this kind of an arrangement is of course where shares are bought on margin with financing from a broker and held in an account with the broker. The extent to which other forms of margin loans are properly characterised as EFCs will involve a facts and circumstances analysis. However, experience shows it is not uncommon for lenders to regard their transactions as conventional loans (and accept potential stay risk) and not require that they qualify as EFCs. This approach will normally be reflected in the loan-to-value ratios and pricing of such loan transactions.

20 What is the structure of the market for listed equity options?

In Canada, the only recognised exchange on which equity options are listed for trading is the MX. Only approved participants of the MX can trade on the exchange. Trades concluded on the MX are novated and cleared by the Canadian Derivatives Clearing Corporation (CDCC). Only clearing members of CDCC can clear transactions at the clearing house. The MX's lead regulator is the AMF and it is also regulated by the OSC. The principal regulators of CDCC are the AMF, the OSC, the British Columbia Securities Commission (BCSC) and the Bank of Canada. Under applicable legislation, the MX and CDCC have the authority to implement their own rules, which regulate the activities of approved participants and clearing members, respectively.

21 Describe the rules governing the trading of listed equity options.

The MX promulgates its own rules pursuant to the self-certification procedure contemplated under the Derivatives Act (Quebec). Rule Six–Trading is the key rule pertaining to the trading of listed equity options. The Regulatory Division of the MX has oversight of the derivatives trading activities of MX-approved participants and the ability to conduct investigations and audits, and sanction breaches of the rules.

22 What categories of equity derivatives transactions must be centrally cleared and what rules govern clearing?

All trades in equity options listed on the MX must be centrally cleared at CDCC. The rules of CDCC govern the clearing of these trades.

There are no mandatory central clearing requirements for other equity derivatives at present. In January 2017, the CSA published National Instrument 94-101 to provide for the mandatory central clearing of designated categories of derivatives involving local counterparties in Canada where, subject to certain intra-group exceptions, both parties to the transaction are one of: a clearing member of a regulated clearing agency; an affiliate of such clearing member that has a month-end gross notional amount of outstanding derivatives of C$1 billion; or a local counterparty in Canada that, together with its affiliates, has an aggregate month-end gross notional amount of outstanding derivatives greater than C$500 billion. These requirements came into effect for clearing participants on 4 April 2017 but have been delayed until August 2018 for other parties to allow for amendments excluding investment funds (as defined in National Instrument 81-106) and trusts from the latter two categories of entities subject to the Instrument. The specific categories of transactions designated by the CSA for mandatory clearing are all interest rate swaps or forward rate agreements. Additional categories of mandatory clearable derivatives may be designated in future under the National Instrument but, given the relatively thin market in equity derivatives in Canada, they appear unlikely to be included.

23 What categories of equity derivatives must be exchange-traded and what rules govern trading?

Canadian law does not presently require that equity options be listed and traded on an exchange. The listing of certain types of equity options is driven by the MX itself in response to market demand. As noted in question 21, the rules of MX govern trading in the equity options that are listed on this exchange.

There are no mandatory trade execution requirements in Canada at present. However, in January 2015 the CSA published for comment Consultation Paper 92-401 that contemplates a regulatory regime for derivatives trading facilities (DTFs) and a draft National Instrument is expected to be published in 2018. It is uncertain at present whether any equity derivatives will be mandated for trading on DTFs in Canada.

24 Describe common collateral arrangements for listed, cleared and uncleared equity derivatives transactions.

In the case of cleared derivatives, the margin requirements of the relevant clearing agency, and any additional margin requirements of a clearing member will need to be complied with. IIROC also imposes certain margin rules on its regulated dealer members. National Instrument 94-102, which came into force on 3 July 3 2017, imposes requirements on clearing agencies and clearing intermediaries designed to protect customer collateral for cleared derivatives.

Collateral posting requirements for uncleared derivatives are generally a matter for negotiation between the parties. Collateral arrangements are typically documented under an ISDA CSA or a bespoke pledge agreement with eligible collateral comprising cash or securities. If the collateral includes investment property such as securities or securities accounts, secured parties may perfect their security interests through, among other things, the use of tri-party control agreements. Mandatory margin requirements, which would extend to equity derivatives, are discussed in the response to question 25 below.

25 Must counterparties exchange collateral for some categories of equity derivatives transactions?

In addition to the margin requirements imposed by exchanges such as the MX and clearing agencies, OSFI Guideline No. E-22 imposes phased-in mandatory margin requirements in respect of non-centrally cleared derivatives on federally regulated financial institutions in Canada. E-22 is based on the Basel Committee on Banking Supervision and International Organisation of Securities Commissions framework and requires that both initial and variation margin be posted if specified thresholds of outstanding uncleared derivatives transactions are met, with initial margin determined based on either a model or the Guideline's schedule. The Guideline also specifies what constitutes eligible collateral and addresses applicable haircuts.

In July 2016, the CSA published for comment Consultation Paper 95-401 Margin and Collateral Requirements for Non-Centrally Cleared Derivatives, which will impose comparable requirements on Canadian entities that are not subject to OSFI Guideline E-22. The comment period closed in September 2016 but a draft National Instrument has not yet been published.

26 What is the territorial scope of the laws and regulations governing listed, cleared and uncleared equity derivatives transactions?

The rules of the MX and CDCC apply to approved participants and clearing members, respectively. Approved participants may be incorporated outside Canada and be subject to foreign regulatory oversight (eg, by the Commodity Futures Trading Commission). The rules of the MX are applicable to such foreign approved participants. The CDCC does not presently admit foreign clearing members.

Derivatives data reporting requirements will apply to OTC equity derivatives transactions (whether cleared or uncleared) if at least one party is a local counterparty in a Canadian jurisdiction that requires trade reporting. The definition of 'local counterparty' includes a foreign affiliate if the foreign affiliate's liabilities are guaranteed by an entity that is itself a local counterparty in Canada.

Provincial laws governing trading in securities and derivatives can apply if a party to the transactions is in Canada or if the issuer is in Canada (eg, insider reporting, early warning reporting or takeover bid rules). The prospectus requirement or exemptions therefrom will depend upon facts and circumstances. However, they will apply in all provinces where the purchaser is in the province and in certain provinces where the issuer has a substantial connection to the province (such as Alberta and British Columbia) or the trade is otherwise considered to be a distribution in the province owing to the circumstances and relevant connecting factors. Securities laws are broad in scope and include the mandate to protect the integrity of capital markets, therefore, securities regulators may also exercise jurisdiction where there is a public market in Canada or they otherwise consider it to be in the public interest to do so.

27 What registration or authorisation requirements apply to market participants that deal or invest in equity derivatives, and what are the implications of registration?

At present, apart from the derivatives dealer registration requirements under the Quebec Derivatives Act, there are no registration regimes specific to derivatives dealers. In certain of the provinces where derivatives are deemed to be securities under local securities laws, there are broad exemptions from registration requirements available when the parties to the transaction are 'qualified parties'. In Quebec, there are similar exemptions when the parties are 'accredited counterparties'. A draft National Instrument providing for derivatives dealer registration is expected to be released in the first part of 2018. It remains to be seen whether the broad registration exemptions referred to above will be carried forward or replaced by a universal registration regime with exemptions from particular requirements available only based on the nature of the client faced or recognition of substantively similar regulation of the dealer in another jurisdiction.

In April 2017, the CSA published for comment draft National Instrument 93-301 setting out proposed business conduct rules for derivatives dealers and derivatives advisors. The draft Instrument adopts a two-tiered approach to regulating market conduct. In the first instance, certain minimum standards (eg, fair dealing, conflicts of interest management, know-your-client and suitability, disclosure requirements and duties imposed on 'senior derivatives managers') will apply to the conduct of all derivatives dealers and derivatives advisers, regardless of whether the entity is registered, required to be registered or exempted from the requirement to be registered. Additional disclosure requirements, restrictions and standards of care, among other things, would apply only to activities involving less sophisticated derivatives parties (ie, the retail market). The draft Instrument contemplates a range of exemptions in the case of qualified derivatives end-users, as well as IIROC-member investment dealers and Canadian financial institutions that meet equivalent regulatory requirements. Significantly, the proposed instrument would also exempt foreign derivatives dealers and advisers located in certain jurisdictions that the CSA will have determined achieve substantially the same objectives, on an outcomes basis, as the proposed Instrument, subject to certain terms and conditions. The CSA note that their equivalence analysis of foreign market conduct rules in the leading derivatives markets is still pending. The comment period for the draft Instrument closed in September 2017.

Dealers that engage in derivatives transactions with retail clients in Quebec are required to be registered as derivatives dealers. While derivatives dealer registration requirements have not yet been implemented elsewhere in Canada, derivatives transactions with retail clients (eg, equity-based CFDs) may be deemed to be securities, and the entities and platforms offering such products may consequently be subject both to securities dealer registration and to exchange recognition requirements.

28 What reporting requirements apply to market participants that deal or invest in equity derivatives?

See question 9. Apart from the derivatives data reporting requirements now imposed in all of the provinces and territories of Canada (and that do not draw any distinction between transactions where the underlying interest is a security versus something else), a number of reporting requirements can potentially apply if, for example:

- one of the parties to the transaction is an insider of a public company issuer and the transaction changes the insider's economic exposure to the issuer;
- the transaction operates to give a party deemed beneficial ownership of a security of a public company issuer and thereby triggers the early warning reporting requirements in Canada; or
- the transaction is itself deemed to be a security and the trade of that security gives rise to the need to rely on a prospectus exemption (which, in turn, may give rise to a trade reporting requirement).

29 What legal issues arise in the design and issuance of structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares? What additional disclosure and other legal issues arise if the structured product is linked to a proprietary index?

These will depend upon whether the offering of the structured products constitutes a public or private offering of securities. In the former case, if the products are securities, the general prospectus disclosure and filing requirements of applicable securities laws will apply. However, issuers must also take into account the detailed discussions set out in CSA Staff Notices 44-304 and 44-305 regarding pre-clearance and disclosure requirements for structured notes linked to indices and equities, for example. These include requirements relating to, among other things, suitability, transparency concerns with respect to linkage to proprietary indices or where information relating to the issuers of underlying securities is not in the public domain, and issuer liability for third-party information. Moreover, if the issuer is Canadian, the offering may generally be made only through registered Canadian dealers.

If the offering is conducted on a private placement basis, there will generally be no mandated disclosure requirements, although the usual practice would be to provide investors with an offering memorandum that provides near prospectus-level disclosure. As discussed in question 13, offering memoranda may be subject to statutory liability for misrepresentations, post-trade filings may be required and dealer registration requirements may apply.

Certain types of 'exempt' instruments, such as principal-protected notes issued by Canadian banks, are subject to disclosure requirements under the Bank Act's Principal Protected Notes Regulation. In Quebec, the Derivatives Act imposes AMF approval requirements for the issuance of structured products to investors.

From a tax perspective, most of the structured products issued by Canadian resident issuers that produce a return linked to a third party's shares, or to a basket or index of third-party shares, are structured as linked notes potentially subject to the ITA's prescribed debt obligations rules that impute an annual return (in the form of interest) to the noteholder regardless of whether an amount is actually paid during the year. The rules are broad but are administered by the CRA in a circumspect manner and most linked note issuances are designed to fit into one or more of the CRA's administrative positions under which it will not apply these rules. As a result of certain recent amendments to the ITA, gains realised by an investor on the disposition of a linked note prior to maturity in a secondary market transaction will generally be deemed to be interest as opposed to a capital gain. Prior to these amendments, investors who disposed of a linked note in such circumstances typically took the position that any resulting gain was a capital gain even though the same return would be characterised as interest income if the linked note was held to maturity.

In the case of non-resident holders of linked notes, the principal issue is whether the return, when paid or credited, would be subject to the ITA's interest withholding tax rules and liable to withholding tax as 'participating debt interest'. However, again, the CRA has interpreted the scope of this definition more narrowly and, in the majority of cases, the terms of the linked notes are structured such that the return paid to holders does not fall within the definition – at least insofar as it is administered by the CRA.

With respect to structured products that are equity securities or derivative instruments, the related Canadian income tax issues would likely be the same as those raised in question 12, but the specific issues will ultimately depend on the terms of the specific structured product being analysed.

30 Describe the liability regime related to the issuance of structured products.

See question 13.

31 What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is convertible for shares of the same issuer?

The prospectus, registration and other requirements discussed in question 8 apply to the distribution by an issuer of an exchangeable, convertible or exercisable security, including that the original security be qualified by a prospectus or issued in reliance on an applicable prospectus exemption. A prospectus exemption is available for the issuance by the issuer to a security holder of the issuer of an underlying security of its own issue or of a reporting issuer where the original security is exchangeable, convertible or exercisable in accordance with its terms. Generally, the underlying security will be subject to a hold period where the original security was issued in reliance on certain prospectus exemptions, although the time periods that both the original security and the underlying security have been held can be tacked. Where the original security is qualified by a prospectus, the issuer or selling

Update and trends

On 28 September 2017, the CSA (other than the BCSC) announced the adoption of Multilateral Instrument 91-102 Prohibition of Binary Options and a related Companion Policy, aimed at banning the sale to individuals of binary options having a term to maturity of less than 30 days. The ban took effect in all Canadian jurisdictions (other than British Columbia) on 12 December 2017, subject to government ministerial approvals in certain jurisdictions. Currently, no person can legally sell binary options to retail investors in British Columbia, as described in BCSC Notice 2017/02 published on 28 September 2017 warning investors about binary options trading schemes. These initiatives respond to a growing number of complaints about alleged frauds and other market abuses by the operators of unauthorised web-based platforms offering binary option products, and follow a series of investor alerts issued by Canadian securities regulators over the past few years warning of the risks of 'investing ' in these products.

security holder may also be required to provide a contractual right of action to any purchaser of the underlying security where the prospectus contains a misrepresentation. Other applicable requirements including post-trade reporting and stock exchange approval and disclosure are discussed in question 8. For the purposes of insider reporting and early warning reporting, a person or company will also be deemed to beneficially own any underlying security where the security may be acquired on exchange, conversion or exercise, etc, within 60 days.

Absent the application of an applicable rule in the ITA that provides for a tax rollover (or similar non-recognition treatment), the exercise of a conversion right embedded in a security will generally result in a taxable disposition of the convertible security and an acquisition of the underlying security. However, the ITA contains a specific rule under which debt or shares issued by a corporation can be converted into shares of the same corporation on a tax-deferred basis. In general terms, to qualify for this rule, the holder must not receive any consideration on conversion other than shares of the corporation. If the convertible security is a debt obligation, conversion must be solely at the holder's option and embedded in the terms of the debt obligation. The ITA also contains other rollover rules that may apply to convertible shares. With respect to non-resident holders of a convertible debt obligation issued by a Canadian resident, there has been some concern that any conversion premium realised by the holder on the conversion of the obligation could be characterised as participating debt interest (see question 29). That said, the CRA has more recently provided guidance to the effect that such a conversion premium will not be participating debt interest in most cases where the convertible debt has market-standard terms.

32 What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is exchangeable for shares of a third party? Does it matter whether the third party is an affiliate of the issuer?

See question 31.

Absent the application of an applicable rule in the ITA that provides for a tax rollover (or similar non-recognition treatment), the exercise of an exchange right embedded in a security will generally result in a taxable disposition of the exchangeable security and an acquisition of the underlying security. The rollover rules in the ITA that apply to convertible shares and convertible debt will not apply to exchangeable securities. With respect to non-resident holders of exchangeable debt, there is a risk that any exchange premium received on the exchange could be characterised as participating debt interest for Canadian non-resident withholding tax purposes. While the CRA has not provided the same level of guidance as it has for convertible debt, depending on the facts, it may be possible to take the position that any such exchange premium should not be characterised as participating debt interest based on the CRA's interpretation of the participating debt interest definition in different contexts.

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ISBN 978-1-78915-021-6