Foreign Derivatives Dealers and Advisors Given a Lighter Touch under the Proposed Canadian Derivatives Registration Regime

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- The Canadian Securities Administrators' proposed National Instrument 93-102 *Derivatives: Registration*, prescribing the derivatives dealer and advisor registration regime, proposes relatively light regulation of foreign firms that restrict their counterparties and clients to *eligible derivatives parties*.
- Released for comment on April 19, 2018, the draft NI 93-102 proposes an exemption for foreign registered dealers similar to the international dealer exemption.
- For those foreign dealers and advisors that must register, NI 93-102 will also allow for substituted compliance with respect to certain specified foreign rules.
- **The comment period is open until September 17, 2018**.

Background

Currently, no Canadian jurisdiction other than Quebec has a dealer or advisor registration regime tailored to participants in the OTC derivatives market. Securities legislation does in certain Canadian jurisdictions already require registration of derivatives dealers and advisors, but blanket exemptions are currently in place in most of those jurisdictions allowing them to deal with qualified parties without registration. This Registration Rule will provide for a derivatives specific registration regime and replace the existing exemptions.

This post highlights those aspects of the rule that are relevant to non-Canadian dealers and advisors. For a more general review of the rule see our post – Derivatives Registration Rule Released.

Triggers for Application

Applies to OTC derivatives (s. 3)

NI 93-102 will apply to those that advise or deal in derivatives. "Derivatives" for this purpose means "OTC derivatives", as defined under the same Product Determination Rules that apply to trade reporting and other derivatives rules.

Business triggers (s. 6)

Any dealer that engages in the business of trading in derivatives in a Canadian jurisdiction is subject to the statutory registration requirement in that jurisdiction. Part 3 of the proposed Companion Policy 93-102 (found at the end of the proposed rule) sets out a number of factors that should be considered in determining whether the business trigger is met. At a high level, these are:

- acting as a market maker;
- directly or indirectly carrying on the activity with repetition, regularity or continuity;
- facilitating or intermediating transactions;
- transacting with the intention of being compensated (e.g. spreads, built in fees);
- directly or indirectly soliciting, by any means, in relation to transactions;
- engaging in activities similar to a derivatives adviser or dealer; and
- providing derivatives clearing services.

These factors are elaborated on in the CP 93-102. Similar factors are set out for advising.

Under the rule, certain actions with respect to a "non-eligible derivatives party" (a concept we address below) will also trigger the registration requirement. Described in CP 93-102 as additional registration triggers, and seemingly **not** limited to dealers carrying on business in the jurisdiction, these include:

- transacting with, for or on behalf of such a party; and
- soliciting or initiating contact with such a party for the purpose of encouraging it to transact in a derivative.

Other persons that act as clearing agents are also subject to the dealer registration requirement, again seemingly regardless of the business trigger.

Categories of registration

Two categories of dealer registration are provided for, namely

- derivatives dealer; and
- restricted derivatives dealer.

Essentially, a **restricted derivatives dealer** can deal only in the derivatives specified in its registration order, subject to the conditions in that order (for example, "FX only" in the case of a registered FX dealer). There are parallel provisions for advisors.

Dealers will also have to be IIROC dealer members to deal with individuals who are not eligible derivatives parties. This will require many FX dealers to become IIROC members, which may not be feasible for many of those who are currently in this market.

There are also registration requirements for **individuals** who represent registered dealers.

We address the registration details in our more general blog post, Derivatives Registration Rule Released. We are sure though that the proposed requirements that apply to registered dealers, including capital requirements, requirements to designate certain positions, policy requirements with respect to risk management, compliance, business continuity and disaster recovery and record keeping will make you very interested in the registration exemptions and substitute compliance provisions that we will now address!

Eligible Derivatives Party

Many of the exemptions, including those specific to non-Canadian firms and individual registrations, apply only if the firm or individual's dealings are restricted to "eligible derivatives parties.

The Rule defines a "derivatives party", which is essentially the dealer firm's counterparty or its client if it is acting as agent or advisor (e.g. as clearing agent). The Rule will define the categories of **eligible derivatives party** (or "EDP" " … let's just get used to the acronym right away because you know that when a defined term has three words you're pretty much forced to adopt an acronym that no one outside the industry will understand. Couldn't this just be "eligible party"? Please.) An **EDP** is similar to the **permitted client** category that applies with respect to the international dealer exemption (IDE) that many market participants rely on with respect to their securities dealings in Canada and also similar to the "accredited counterparty" definition that applied under a number of the blanket registration exemption orders in various provinces. Mercifully, it is one definition applicable in all Canadian jurisdictions. The usual suspects are EDPs, including:

- Canadian financial institutions and their wholly owned subsidiaries;
- registered securities and derivatives dealers and advisors;
- pension funds and their subsidiaries;
- Canadian governments and their crown corporations, wholly owned entities and agencies;
- foreign entities analogous to the above;
- foreign governments and their agents;
- municipalities and their boards and agencies;
- trust companies acting for managed accounts;
- others acting for managed accounts if they are registered or authorized to carry on business as an advisor or derivatives advisor or equivalent in a non-Canadian jurisdiction;
- investment funds with authorized advisors;
- parties guaranteed by other EDPs (subject to some exceptions); and
- qualified clearing agencies.

Of particular interest are those categories of EDP unique to the OTC derivatives market. These categories of EDP depend on the derivatives party making certain specific representations (and not just a general representation that they are an EDP). If the firm reasonably believes the representation, it can be relied on without independent verification of the factual basis of the representation. The Companion Policy sets out an expectation that firms will maintain copies of the representations and have policies and procedures to ensure that they remain current. Whether it's reasonable to rely on a written representation will depend on the particular facts and circumstances of the derivatives party and its relationship to the firm. The firm can consider such factors as:

- the frequency and regularity of the party's derivatives transactions;
- the experience of its staff in derivatives and risk management;
- whether it has independent advice; or
- publicly available financial information.

Experienced derivatives users

The first of these is what we'll call **experienced derivatives users**. These are entities (not individuals) that have represented to the firm (in writing) that:

- they know what they are doing, which means they have the requisite knowledge and experience to evaluate the information provided to them by the firm, the suitability of the product and its characteristics; and
- they have net assets of at least $25,000,000, as shown on their most recently prepared financial statements.

Commercial hedgers

The second is **commercial hedgers**. These are entities (again, not individuals) that represent to the firm in writing that:

- they know what they are doing;
- they have net assets of at least $10,000,000, as shown on the most recently prepared financial statements; and
- they are “commercial hedgers” in relation to the transactions with the firm.

The definition of “commercial hedger” is not restricted in terms of the types of underlying risks that are being hedged. A commercial hedger is an entity that carries on a business and that transacts a derivative that is intended to hedge risks relating to that business. Those risks must arise from **potential changes in value** of one or more of:

- An asset that the entity owns, produces, manufactures, processes or merchandises (or anticipates owning, etc.);
- A liability that it incurs or anticipates incurring; and
- A service that it provides, purchases or anticipates providing or purchasing.

The wording of this definition seems a bit strange in some ways. I would not describe hedging price risk on manufacturing inputs as hedging the *value* of an *asset* that the manufacturer anticipates owning. It’s the change in price or cost before the input is purchased that is being hedged, not its value once it is owned.

Under the blanket exemption orders that apply in many Canadian jurisdictions, commercial hedgers are qualified parties notwithstanding their net asset values, so there is a narrowing of the existing categories in this sense. How much is a strawberry farm worth? Um.

Experienced individuals

These are individuals that have represented to the firm (in writing) that:

- they know what they are doing; and
- they beneficially own “financial assets”, as defined in section 1.1 of National Instrument 45-106 *Prospectus Exemptions*, that have an aggregate realizable value before tax, but net of related liabilities, of at least $5,000,000. Financial assets include cash, securities or a deposit.

Exemptions that Apply to Foreign Dealers and Advisors

General

A number of exemptions from the registration requirements will be of particular interest to non-Canadian firms. The two most important of these are:

- the foreign dealer/advisor general exemptions; and
- the foreign dealer/advisor specific requirements exemptions.

In addition, there is a proposed end-user exemption and two limited notional amount exemptions to the dealer registration requirement that could apply to certain firms.

Foreign firm general exemption (s. 52)

The general registration exemption for foreign firms will apply only to firms whose head office or principal place of business is in one of a list of specified foreign jurisdictions on Appendix B. These will be set out in the final version of the rule. All of the following conditions respecting the firm's business in the particular Canadian jurisdictions in which it carries on business must be met for the exemption to apply:

- All of its derivatives parties (including those it solicits) must be EDPs;
- It must be registered or otherwise authorized under securities, commodities or derivatives legislation in the home jurisdiction to conduct the derivatives activities in that home jurisdiction that it will be conducting with the Canadian derivatives parties;
- It must be subject to and comply with the requirements of the home jurisdiction that the Derivatives Registration Rule will specify (these will eventually be listed in an appendix to the rule); and
- It must notify the regulator of any non-compliance with these home jurisdiction requirements.

CP 93-102 explains that a dealer that is under home jurisdiction laws not subject to or exempt from registration or complying with the specified requirements cannot rely on this exemption. Also, a dealer that is a registered swap dealer under CFTC rules but not subject to registration in its home jurisdiction may not qualify for the exemption since it is home jurisdiction rules that are relevant to the exemption.

Further conditions to relying on the exemption are:

- The firm engages in business as a derivatives dealer in the home jurisdiction;
- One of the following applies in relation to each derivatives party of the firm:
    - It is a registered derivatives dealer or adviser in any Canadian jurisdiction or is exempt from registration under one of:
        - the limited notional amount exemption (see below); or
        - commodity derivatives dealer limited notional amount exemption (see below); or
    - The firm has delivered a written statement disclosing certain information to the derivatives party, namely:
        - the identity of its home jurisdiction;
        - the fact that all or substantially all of its assets may be outside of the Canadian jurisdiction;
        - the fact that there may be difficulty enforcing legal rights against the firm because of the above; and
        - the contact details of the firm's agent for service in the Canadian jurisdiction;
    - Filing Form 93-102 F2, which is a submission to jurisdiction and appointment of a service agent in the jurisdiction; and
    - An undertaking to the relevant Canadian securities regulatory authority to provide it with prompt access to its records on request.

While the Registration Rule will create a **principal regulator** concept for registered dealers and advisors, this will not apply to reliance on exemptions by foreign firms. Therefore, in the case of a foreign firm, **each regulator must receive the required notices and undertakings**.

Foreign advisor general exemption (s. 59)

The general registration exemption for foreign advisors will similarly apply only to firms with a home jurisdiction in certain specified foreign jurisdictions, which will be set out in the final version of the rule. All of the following conditions relating to the advisor's business in the particular Canadian jurisdictions in which it carries on business must be met for the exemption to apply:

- It must advise only EDPs (other than non-tailored advice).
- The firm must be authorized under securities, commodities or derivatives legislation in the home jurisdiction to conduct the derivatives activities in that home jurisdiction.
- It must be subject to and comply with the requirements of the home jurisdiction that the Registration Rule will specify (these will eventually be listed in an appendix to the rule)
- It must notify the regulator of any non-compliance with these home jurisdiction requirements.

Further conditions to relying on the exemption are similar to those for foreign dealers. Also, there is an obligation to inform regulators annually of reliance on the exemption in the prior 12 months.

End-User Exemption – s.49

Subject to the registered dealer exception, a firm will be exempt from the dealer registration requirement of a Canadian jurisdiction if all of the following apply:

- its derivative dealing activities are restricted to EDPs,
- it does not advise non-EDPs (other than non-tailored advice),
- it does not regularly make or offer to make a market in a derivative with a derivatives party,
- it does not regularly facilitate or otherwise intermediate transactions for another, and
- it does not facilitate clearing of a derivative through the facilities of a qualifying clearing agency for another (other than an affiliate)

Some foreign banks might qualify for this exemption if they are not registrants in their home jurisdiction and not conducting dealing activities in Canada or a particular Canadian jurisdiction, but are entering into transactions with Canadian banks as part of their proprietary trading or hedging activities.

Dealers with Limited Notional Amounts – s.50

The limited notional amount exemption might avail dealers with limited market activity in Canada. It will be available if all of the following apply:

- its derivative dealing activities are restricted to EDPs,
- it does not advise non-EDPs (other than non-tailored advice), and
- its aggregate month-end gross notional amount under outstanding derivatives has not exceeded $250,000,000 in the prior 24 calendar months. The transaction of affiliates is included, but not transaction between affiliated entities. For entities with a foreign home jurisdiction only the transactions with Canadian derivatives parties are included in the calculation.

This exemption is not available to those entities that are registrants in any other Canadian jurisdiction or in a foreign jurisdiction if that foreign jurisdiction is specified in what will be Appendix B to the rule.

The CSA is considering a few different approaches to defining "notional amount" and is seeking input on that subject.

Dealers with Limited Notional Amounts under Commodity Derivatives – s.51

Basically this exemption is the same as the limited notional amount exemption except it is restricted to commodity derivatives and has a higher threshold of $1 billion. Commodity derivatives are defined as derivatives that have a commodity as their only underlying asset. “Commodity” is defined as any good, article, service, right or interest of which any unit is, from its nature or mercantile custom, treated as equal to any other unit. It does not include currency, cryptocurrency or a security. (Recall also that certain physically settled commodity derivatives are not considered to be derivatives by virtue of the Product Determination Rules.) This exemption is also subject to the same registered dealer exception that applies to the general Limited Notional Amount Exemption.

This exemption will be available if all of the following apply:

- its derivative dealing activities are restricted to EDPs;
- it does not advise non-EDPs (other than untargeted advice);
- it (and each of its affiliates) is only a derivatives dealer in respect of commodity derivatives; and
- its aggregate month-end gross notional amount under outstanding derivatives has not exceeded $1,000,000,000 in the prior 24 calendar months. The transactions of affiliates are included, but not transaction between affiliates. For entities with a Canadian home jurisdiction all transactions are included but for those with a home jurisdiction outside of Canada only the transactions with Canadian counterparties are included.

The requirement that the entity and its affiliates only conduct commodity derivatives business would exclude those commodity derivatives dealers that are bank or dealer affiliates.

Affiliated Entities – s.53, s.60

If the dealer’s or advisor’s only Canadian derivatives party is an affiliate, the registration requirement will not apply unless the affiliate is an investment firm. However, this exemption does not apply to a firm that is:

- a registered derivatives, securities or futures dealer in any Canadian jurisdiction; or
- registered under securities, commodity futures or derivatives legislation of a foreign jurisdiction which is the home jurisdiction as a derivatives dealer or advisor.

Substitute Compliance

Foreign dealers and advisors: exemptions from specific requirements (ss. 54, 61)

If the foreign dealer or advisor general exemption is not available, a non-Canadian dealer or advisor is required to be registered. However, it will still be exempt from certain specific requirements of the rule in some cases. Eventually the rule will specify certain non-Canadian regulatory authorities and certain Registration Rule requirements that do not apply to authorized derivatives dealers or advisors with a home jurisdiction in those specified jurisdictions as long as they are subject to the equivalent rule in the home jurisdiction. There are conditions to relying on this exemption, namely:

- The firm must engage in business as a derivatives dealer or advisor in its home jurisdiction; and

- The firm must have delivered a written statement disclosing certain information to the derivatives party, namely

    - the identity of the home jurisdiction;
    - the fact that all or substantially all of its assets may be outside of the Canadian jurisdiction;
    - the fact that there may be difficulty enforcing legal rights against the firm because of the above; and
    - the contact details of the firm's agent for service in the Canadian jurisdiction.

The proposed rule does not yet specify the details of these exemptions. There will be an opportunity to comment once those are published in draft.

Last Remarks

As we have all learned in spades through the regulation-making process, the devil is in the details. We recommend that industry participants carefully review the proposed rule and consider how it will apply to their activities in each individual Canadian jurisdiction. **The comment period is open until September 17, 2018**.