Understanding what the derivatives business conduct rule means for your business

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As the industry digests the long anticipated final Multilateral Instrument 93-101 *Derivatives: Business Conduct* (the Rule), many of our clients are wondering "what does this mean for my business?". This article will help you think about whether the Rule applies to your business and, if it does apply, what your firm needs to do and when.

Which OTC derivatives are caught under the new regime?

Before jumping into a discussion of the Rule, we remind market participants to first confirm whether the applicable derivative instruments are, in fact, "in-scope" for the purposes of our OTC derivative regulatory regime, including the Rule. OSC Rule 91-506 *Derivatives: Product Determination* (or the equivalent legislation in the applicable province or territory) and its Companion Policy provide guidance as to which derivative instruments are caught.

Does the Rule apply to my business?

The Rule follows the "catch-and-release" approach to policy design. The business trigger test for determining who the Rule applies to casts a wide net. However, many firms that are caught by the business trigger will be released from all or many of the Rule's obligations by an exemption. For example, many of the Rule's obligations do not apply to investment dealer members of the Canadian Investment Regulatory Organization (CIRO), registered securities advisers, or commodity futures advisers. This means that many registered dealers and advisers will be able to rely substantially on their existing compliance systems, with only a limited number of additions and enhancements required to comply with the Rule and reflect the nature of the derivatives market.

Is my business caught in the wide net?

The Rule applies to derivatives dealers and derivatives advisers (collectively, derivatives firms) and individuals acting for such firms, regardless of registration status.

A person or company is a derivatives dealer if they are in the business of trading derivatives and a derivatives adviser if they are in the business of advising others in relation to derivatives. The determination of whether a firm is in the business of trading derivatives or advising others in relation to derivatives is a holistic analysis. The companion policy to the Rule sets out a list of non-exhaustive factors that may be relevant.

Factors for dealers	Factors for advisers
• Acting as a market maker - routinely standing ready to transact derivatives • Directly or indirectly carrying on the activity with repetition, regularity or continuity • Facilitating or intermediating transactions • Transacting with the intention of being compensated • Directly or indirectly soliciting in relation to transactions • Providing derivatives clearing services	• Registered adviser providing advice to clients on derivatives • Registered adviser managing discretionary client account employing derivatives • Investment dealer providing advice to clients on derivatives/ derivatives trading strategies • Recommending derivatives/ derivatives trading strategies to investors as part of a general solicitation by online derivatives trading platform

If my business is caught, is it released from any obligations by an exemption?

The Rule contains both complete and partial exemptions. If your business can avail itself of a partial exemption, you should consider which obligations still apply and the best way to comply with them.

Exemptions from the Rule as a whole	Exemptions from certain aspects of the Rule
• Transactions with affiliates or advising of affiliates except where the affiliated entity is an investment fund • Certain foreign dealers and advisers in respect of transactions with certain counterparties • Certain end users of derivatives who are not registered under derivatives, securities or commodity futures legislation in any Canadian jurisdiction or equivalent category in their foreign home jurisdiction	• Investment dealer members of CIRO • Registered securities advisers or commodity futures advisers • Dealers trading with an anonymous counterparty through a derivatives trading facility ((the Canadian Securities Administrators (CSA)'s term for a swap execution facility)) • Canadian financial institutions, other than Schedule III banks (which may be able to shelter under the broader exemptions for foreign dealers) • Dealers who (1) only deal with eligible derivatives party (as defined below) and (2) have had a maximum of $250 million in derivatives outstanding in each of the proceeding 24 months (including transactions entered into by certain

	affiliates, but excluding inter-affiliate transactions) • Dealers who (1) deal only in commodity derivatives for which the underlying interest is not a crypto asset, (2) only deal with eligible derivatives parties and (3) have had a maximum of $10 billion of commodity derivatives outstanding in each of the proceeding 24 months

What does my business need to do?

The key question for this assessment is whether your client or counterparty (the derivatives party) is an eligible derivatives party (EDP). The EDP concept reflects the CSA's view that there are certain derivatives parties that do not require the full set of protections because they are sophisticated, have sufficient financial resources to purchase professional advice, or can otherwise protect themselves through contractual negotiation.

Based on whether or not the derivatives party is an EDP, the Rule takes the following tiered approach:

Core obligations of dealers and advisers *Fundamental obligations that apply to dealers and advisers whether the derivatives party is an EDP or not*	• Fair dealing - act fairly, honestly and in good faith • Conflicts of interest - maintain policies and procedures to identify, respond to and, in some cases, disclose all existing or expected material conflicts of interest, some of which are unique in the derivatives context and set out in the CP and some of which can be assessed for materiality based on the sophistication of the derivatives party (i.e., a scenario that might give rise to a conflict with a non-EDP may not in the case of an EDP) • Know your derivatives party (KYDP) - maintain policies to verify and keep current a derivative party's identity and key information • Handling complaints - document and promptly respond to complaints • No Tied selling - cannot pressure a person or company to purchase a product or service by making such purchase a condition of obtaining another product • Segregation and do not use derivative party assets (except if the firm is subject to and complies with NI 94-203 or NI 81-102

	in this regard) • Compliance - maintain policies to assure compliance with securities legislation, derivatives business conduct rules, appropriate experience of personnel • Derivatives party agreement - have derivatives agreement in place before transacting • Recordkeeping obligations - appropriate keeping of records for 7 years (8 in Manitoba)
Core obligations of dealers only (not advisers) *Fundamental obligations that derivatives dealers (but not derivatives advisers) whether the derivatives party is an EDP or not*	• Trade confirmations - promptly provide written confirmations of derivatives transactions. • Senior Managers - designate senior individuals to supervise derivatives activities for each business unit • Reporting - report to securities regulator if a dealer is not in compliance with securities law or business conduct rules and such non-compliance creates a reasonable risk of harm to a party, the capital markets or is a pattern
Additional, context dependent obligations of derivatives dealers and advisers These obligations apply when: 1. the derivatives party is an individual or specified commercial-hedger EDP (unless the additional obligations are waived in writing); or 2. the derivatives party is a non-EDP (the additional obligations cannot be waived)	• Suitability - learn about objectives, finances, risk tolerance, etc. and take reasonable steps to ensure derivative is suitable • Referrals - only engage in permitted fully disclosed referrals • Margin - hold initial margin at a permitted depository and do not use it without consent (unless subject to and in compliance with NI 94-102 or NI 81-102) • Disclosure - relationship disclosure information, pre-transaction disclosure, post-trade disclosure, valuations (daily, quarterly or monthly, as applicable) and statements

In order to fulfil only core obligations with respect to a derivatives party that is an individual or eligible commercial hedger EDP, the derivatives party must waive the additional obligations in writing. The Rule provides flexibility for such derivatives parties to choose to waive some or all of the additional obligations. This could create complexity for derivatives firms, since not all individual or eligible commercial hedger EDPs will necessarily choose the same waivers.

Who counts as an EDP?

EDPs are those that fall into the categories outlined in the table below. Many of our clients are pleased that the test for whether a derivatives party is an EDP is a bright line test. The “knowledge and experience” representations in previous drafts of the Rule have been discarded.

Regulated entity EDPs	Other entity EDPs	Individual EDPs
• Financial institutions and affiliates • Registered securities and derivatives dealers and advisers, securities and commodity futures advisers and investment dealers in Canada and abroad • investment funds that are managed by a registered investment fund manager or are advised by an adviser • Pension funds and their wholly owned subsidiaries • Canadian and foreign governments and agencies • Qualified clearing agencies	• Non-individuals that have net assets of at least C$25-million • Non-individual that has represented in writing that it is a “commercial hedger” • Non-individuals whose obligations under derivatives are fully guaranteed or otherwise fully supported under a written agreement by one or more EDPs (other than a commercial hedger or an Individual EDP)	• Individuals that have net assets of at least C$5-million • Individuals that have represented they are “commercial hedgers”

How long does my business have to get all this done?

Different parts of your business will need to comply with the Rule by different deadlines. From a regulatory perspective, the purpose of these transition provisions is to encourage firms to focus on bringing new business and contracts involving more vulnerable clients and counterparties into alignment with the Rule first, before focusing on more sophisticated parties. The relevant dates are as follows:

By Sept. 28, 2024 (the Effective Date)	All new derivatives contracts must comply with the Rule by the Effective Date. This means you have less than a year to bring policies, procedures and documentation for new business up to speed.
By Sept. 28, 2025	A waiver of the additional obligations is required to fulfil the core obligations only for individuals and commercial hedgers who are EDPs, but you have

	a grace period until Sept. 28, 2025 to get the waivers signed.
By Sept. 28, 2029	For pre-existing contracts entered into prior to the Effective Date, you can treat non-individual derivatives parties as EDPs until Sept. 28, 2029 on the basis of existing documentation, provided that the derivatives party has given a written representation (or the derivatives firm has taken other reasonable steps to confirm), prior to the Effective Date, that they are one of the following: • a permitted client under NI 31-103 • in Ontario, a non-individual accredited investor, as defined in NI 45-106, • an accredited counterparty as defined in the Derivatives Act (Quebec) • a qualified party as defined in blanket orders of Alberta, British Columbia, Manitoba, New Brunswick, Nova Scotia and Saskatchewan • an eligible contract participant under The United States Commodity Exchange Act • a financial counterparty, as defined under the European Market Infrastructure Regulation • a non-financial counterparty, which exceeds specified clearing thresholds under the European Market Infrastructure Regulation After Sept. 28, 2029, these pre-existing contracts will need to be updated to include a specific EDP representation.

What about the registration rule for OTC derivatives?

While it was initially contemplated that the business conduct and registration rules would be published contemporaneously, the implementation of a national harmonized registration rule for OTC derivatives has been delayed. As a result, the current regulations and rules that require registration continue to apply. This analysis must be conducted on a province-by-province basis and we recommend contacting counsel to discuss your current activities to determine how all of these rules apply to your business.

There is so much to consider and do – who can help?

Your trusted legal counsel can help you plan so that your business meets the required timetable and craft solutions that meet the regulatory requirements and are tailored to

your business needs. Please reach out to one of the members of BLG's internationally recognized derivatives team or your usual BLG contact to get started.

By

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