Canada Business Conduct Rules For Derivatives Dealers

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On April 4, 2017, proposed business conduct rules for derivatives dealers and derivatives advisers were published by the Canadian Securities Administrators ("CSA"). These rules, set out in Proposed National Instrument 93-101 *Derivatives: Business Conduct* and its Companion Policy 93-101CP (collectively, the "Business Conduct Rules"), are meant to help protect investors, reduce risk, improve transparency and accountability and promote responsible business conduct in the over-the-counter ("OTC") derivatives markets. The Business Conduct Rules represent only part of the proposed Canadian derivatives registrant regime. The second part of this regime, a proposed registration rule for derivative market participants, is expected to be released by the CSA this summer. The CSA has established a lengthy comment period for the Business Conduct Rules, ending on September 1, 2017, so that the registration rule and the Business Conduct Rules can be considered together.

While we understand that the proposed registration rule will not be out for comment until early summer, the Companion Policy to the Business Conduct Rules dedicates a full page of commentary to the definition of "derivatives adviser" and "derivatives dealer". This commentary, combined with the proposed draft exemptions for entities regulated by the Office of the Superintendent of Financial Institutions ("OSFI") and the Investment Industry Regulatory Organization of Canada set forth in the Business Conduct Rules, clearly reflects the direction of the CSA as to the type of entities that may be required to be registered under the new regulatory regime.

The Business Conduct Rules include a comprehensive set of rules that deal with fair dealing, conflicts of interest, know your client obligations, suitability, pre-trade disclosure, reporting, compliance, senior management duties, recordkeeping and the treatment of derivative party assets. Many of these requirements are modelled on the conduct requirements that apply to registered dealers and advisers under National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("NI 31-103"). Like these existing requirements, the Business Conduct Rules take a two-tiered approach to investor protection, based on the level of sophistication or financial resources of the investor. The CSA included a very useful table in its publication of the application of the business conduct requirements and how they apply to different types of clients; we have reproduced the table at the end of this bulletin.

Scope of the Business Conduct Rules

Derivatives dealer and derivatives adviser are defined under the Business Conduct Rules using a business trigger concept. A derivatives dealer is a person or company engaging in or holding itself out as engaging in the trading in derivatives, whether as principal or agent. A derivatives adviser is a person or company engaging in or holding itself out as engaging in the business of advising others as to transacting in derivatives. Both definitions also include any other person or company that is required to be registered as a derivatives dealer or derivatives adviser. We expect that the proposed registration rule will shed more light on the application of this additional provision.

It is expected that the broad nature of these definitions will capture non-traditional securities registrants, such as non-federally regulated financial institutions, money services businesses and commodity risk managers.

The Business Conduct Rules creates a category of "eligible derivatives party" ("EDP"), which is based on the "permitted client" definition under securities legislation and is meant to include those parties that do not need the full set of protections under the Business Conduct Rules because of their levels of sophistication or financial resources. Similar to the "permitted client" definition, EDPs include regulated entities and sophisticated clients that have net assets of at least $25 million for corporates and $5 million for individuals. Notably absent from the definition of EDP is the general "commercial user" subset of clients that are currently contained in certain provincial blanket orders.

As discussed below, only a subset of the Business Conduct Rules apply to dealings with EDPs. Adding to the two-tiered approach, the CSA proposes an additional subset for individuals EDPs who may or may not waive certain protections. For this purpose, we have used the term EDP to include individuals who are EDPs and who have provided a written waiver of certain protections.

Business Conduct Rules that Apply to All Derivative Parties

The fair dealing, conflicts of interest and general know-your-derivatives-party ("KYDP") obligations are considered by the CSA to be fundamental. Accordingly, these obligations apply to all derivatives firms when dealing with or advising derivatives parties.

The fair dealing provisions, which are consistent with NI 31-103, are meant to be flexible and to take into account the relationship between the derivatives firm and the derivatives party. The KYDP obligations include verifying identity, verifying whether the derivatives party is an EDP, determining if the derivatives party is an insider, and compliance with anti-money laundering and terrorist financing obligations.

Business Conduct Rules that Do Not Apply to Eligible Derivatives Parties

Certain obligations, including the derivatives party-specific needs and objectives, suitability, disclosure regarding the use of borrowed money or leverage obligations, handling complaints, tied selling, and fair terms and pricing, do not apply if a derivatives firm is dealing with or advising an EDP. Tied selling, such as offering a loan on the condition that the derivatives party purchases another product or service, such as a swap to hedge the loan, from the derivatives firm or one of its affiliates is prohibited unless the derivatives party is an EDP. This tied-selling restriction is not intended to prohibit relationship pricing or other beneficial selling arrangements similar to relationship pricing. The Business Conduct Rules require derivatives firms to have policies and procedures in place that are designed to obtain the most advantageous terms reasonably available when acting as agent for a derivatives party, and to make a reasonable effort to provide a price that is fair and reasonable taking into account all relevant factors to a derivatives party when transacting as principal.

The Business Conduct Rules also impose disclosure obligations designed to keep the derivatives parties informed when the derivatives firm is not dealing with or advising an EDP. These disclosure obligations address the relationship between the parties, the products and services that the derivatives firm may provide, information required to be able to assess the material risks of transacting in the derivative, and the material characteristics of the derivative.

Treatment of Derivative Party Assets and Reporting

Additional requirements related to segregation of assets, the holding of derivatives party assets, and restrictions on the use and investment of those assets are also included. This includes a requirement that assets must be held in one or more accounts at a permitted depository that are clearly identified and separate from the property of all persons who are not a derivatives party of the derivatives firm. Certain of these requirements do not apply if a derivatives firm is dealing with or advising an EDP. In addition, the Business Conduct Rules include mandatory reporting requirements, including monthly statement obligations.

Compliance, Recordkeeping and Obligations on Senior Derivatives Managers

As expected, the Business Conduct Rules impose an obligation on derivatives firms to maintain appropriate policies and procedures.

What is unexpected, however, is that the Business Conduct Rules impose certain supervisory, management and reporting obligations on senior derivatives managers, who are those individuals responsible for the derivatives activities of a particular business unit. The intent is to make senior management responsible for the effective and efficient management of their business units.

Exemptions

Derivatives end-users, which are those entities that trade derivatives for their own account for commercial purposes, are exempt from the Business Conduct Rules

provided that they do not undertake certain activities that would suggest that they are in the business of trading or advising in derivatives.

In addition, foreign derivatives dealers and advisers who are regulated under similar foreign laws may be exempt from some of the Business Conduct Rules.

Expected Impact

We expect that the Business Conduct Rules will have little real impact on the activities of Canadian banks and securities dealers, as these firms are already subject to substantially similar rules. However, given the express focus on derivatives and the individual liability that may be imposed on senior managers, it will likely lead to an extensive review of existing policies and procedures and client-facing documents to ensure compliance with these specific obligations.

Perhaps the larger impact of the Business Conduct Rules will be felt by those firms that are now caught in the derivatives regulatory web, but are not otherwise regulated by OSFI or as securities dealers or advisers with the provincial securities commissions.

Contact Us

If you have any questions about the Business Conduct Rules, please contact one of the authors of this bulletin or any other member of the BLG Derivatives Group. BLG is ranked as the Number One Law firm in Canada for Derivatives by *Derivatives Weekly* and was named Canada Law Firm of the Year at Global Capital's Americas Derivatives Awards for the years 2014, 2015 and 2016. BLG's Derivatives Group is a multi-disciplinary team of lawyers that cuts across several of our practice groups. The team is experienced in negotiating derivatives documentation with sell-side and buy-side market participants around the world. Our clients include financial institutions, investment dealers, futures commission merchants, market intermediaries, securitization conduits and a wide variety of derivative end-users, such as mutual funds, hedge funds, pension funds, other investment vehicles, commodity producers, real estate firms, insurance companies, risk management firms and other corporate end-users. Our advice covers derivative structuring and document negotiation, regulatory compliance, tri-party collateral control practices and close-out issues. We also advise on compliance and registration requirements relating to derivatives in Canada.

Application of Business Conduct Requirements

Regulatory Requirement	Derivatives firms dealing only with EDPs	Derivatives firms dealing with non-EDPs	Derivatives advisers acting for managed account
General obligations toward all (Part 3 Div 1) • Fair dealing	√	√	√

• Conflict of interest management • General/gatekeeper know-your-derivatives party			
Additional obligations and restrictions (Part 3 Div 2–3) • Derivatives-party-specific know-your-derivatives party • Product suitability • Permitted referral arrangements • Leverage/borrowing disclosure • Complaint handling • Prohibition on tied selling • Fair terms and pricing		√	√
Client and counterparty accounts (Part 4) • Relationship disclosure • Pre-trade disclosures re. risk, product, price, and • compensation • Report daily valuations • Notice by non-resident registrants • Holding of assets1 • Use and investment of assets • Transaction confirmations2		√	√

• Monthly statements			
Compliance and recordkeeping (Part 5) • Compliance and risk management systems • Senior manager certification • Client/counterparty agreement • Recordkeeping	√	√	√

[1] A basic segregation requirement applies in all circumstances, but most of the asset requirements only apply in the non-EDP context.

[2] A basic transaction confirmation requirement applies in all circumstances, but the more detailed requirement applies only in the non-EDP context.

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