Long-awaited Proposed Canadian Derivatives Registration Arrives

April 24, 2018

With the publication of Proposed National Instrument 93-102 *Derivatives: Registration* and its Companion Policy 93-102 (collectively, the "Derivatives Registration Rule") by the Canadian Securities Administrators ("CSA") on April 19, 2018, the days are finally over for those wondering what the “second half” of Canada’s over-the-counter ("OTC") derivatives registration regime will look like. As we reported in our bulletin on April 6, 2017, the “first half” of this regime was published in the form of Proposed National Instrument 93-101 *Derivatives: Business Conduct* and its Companion Policy 93-101CP (collectively, the "Business Conduct Rule"). Together, the Derivatives Registration Rule and the Business Conduct Rule are intended to implement a comprehensive regime for the regulation of firms and individuals that are in the business of trading and advising on OTC derivatives, similar to the regime implemented by National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*(“NI 31-103”) with respect to the regulation of firms and individuals that are in the business of trading and advising on securities.

The Derivatives Registration Rule contains both firm and individual categories of registration, a business trigger test to determine whether a firm is required to register, obligations and requirements applicable to registered firms and individuals and exemptions from the requirement to register (such as exemptions for non-Canadian derivatives firms). The Derivatives Registration Rule also maintains the approach of tailoring obligations and requirements depending on the sophistication level or financial resources of the investor. As in the Business Conduct Rule, such an investor is defined as an “eligible derivatives party” (“EDP”).1However, the Derivatives Registration Rule includes certain variations on the familiar themes of NI 31-103 that enhance the obligations and requirements on derivatives firms. These are in addition to the obligations and requirements found in the Business Conduct Rule, which apply regardless of whether a derivatives firm is registered or exempt.

The comment period for the Derivatives Registration Rule ends on September 17, 2018 and the CSA has asked for comments on a number of specific proposals. The CSA expects to publish the Business Conduct Rule for a second comment period shortly, so that there will be considerable overlap of each instrument’s comment period. We would be happy to assist in preparing your comments.

The Framework: Firm and Individual Categories of Registration

Firm Categories of Registration

There are two principal categories of firm registration: derivatives adviser and derivatives dealer.2A firm is required to register if it is in the business of trading OTC derivatives, in the business of advising others on OTC derivatives, or holding itself out as being in the business of trading or advising. Companion Policy 93-102 includes a non-exhaustive list of factors to determine whether a firm is in the business of trading in, or in the business of advising others on, OTC derivatives.

A firm may also have to register as a derivatives dealer if it:

- transacts with, for or on behalf of a non-EDP;
- solicits or initiates contact with a non-EDP for the purpose of encouraging that non-EDP to transact in an OTC derivative or to offer a service relating to a transaction or transactions;
- on behalf of another person or company, other than an affiliated entity, facilitates the clearing of one or more OTC derivatives through a clearing agency or a clearing house, as applicable.

These three factors are in addition to the business trigger concept and represent a departure from NI 31-103, which relies solely on the business trigger concept to determine whether a firm is required to register.

Another interesting variation in the Derivatives Registration Rule is that only derivatives dealers who are also dealer members of the Investment Industry Regulatory Organization of Canada ("IIROC") may transact with an individual who is not an EDP. Derivatives firms that are required to be dealer members of IIROC will also be required to be registered with the CSA (presumably as an investment dealer, although this is not stated in the Derivatives Registration Rule.)

What is perhaps most interesting is the firm category that hasn't (yet) been proposed, that of "Large Derivative Participant." This is a category of registration that the CSA proposed in its April 2013 derivatives registration regime consultation paper. Such a category may be coming in the future — the CSA has stated that, after additional analysis relating to Canadian derivatives markets, a future version of the Derivatives Registration Rule, which will be published for comment, may include an additional registration category for large non-dealer derivatives participants.

Individual Categories of Registration

The Derivatives Registration Rule contemplates five categories of individual registration: derivatives ultimate designated person ("Derivatives UDP"); derivatives chief compliance officer ("Derivatives CCO"); derivatives chief risk officer ("Derivatives CRO"); derivatives dealing representative ("Derivatives Dealing Rep"); and derivatives advising representative ("Derivatives Advising Rep"). A registered derivatives firm must ensure that each of these individuals has the education, training and experience that a reasonable person would consider necessary to perform the activity competently, including understanding the structure, features and risks of each OTC derivative that the individual transacts or recommends.

These categories of registration are in addition to the senior derivatives manager role introduced in the Business Conduct Rule.

The Derivatives UDP has no other proficiency requirements. He or she must be the CEO (or equivalent) of the firm or, if the registered derivatives firm has other significant business activities, the officer in charge of the division of the registered derivatives firm that conducts the activities that require the firm to be registered.

Derivatives CRO is a new category of registration that is not found in NI 31-103. He or she must be an officer or partner of the registered derivatives firm and must meet certain proficiency and experience requirements, namely one of:

- the CFA Charter and the Risk Manager Designation3(or equivalent certification as a risk manager);
- the Conduct and Practices Handbook Course Exam and certain relevant derivatives experience; or
- the PDO Exam and certain derivatives risk management experience.

There are prescribed proficiency and experience requirements for each of the other individual categories of registration. These requirements are largely similar to those found in NI 31-103 (or provincial legislation applicable to trading or advising on exchange-traded derivatives), of course tailored for the OTC derivatives context. The CSA anticipate amending the proficiency requirements in the future as OTC derivatives' specific designations or courses are offered. The Derivatives Registration Rule also contains a general three year time limit on the currency of required proficiencies, except for the CFA and the Risk Manager Designation. Interestingly, unlike NI 31-103, the CIM designation is not included in this exception to the three year exam currency limitation.

The Obligations: Registered Firm and Individuals

Registered Firm Requirements and Obligations

While many of the requirements and obligations applicable to derivatives firms (both registered and exempt) are found in the Business Conduct Rule, additional requirements and obligations of registered derivatives firms are included in the Derivatives Registration Rule.

- *Capital requirements*. The CSA expects that the minimum capital requirements will be consistent with capital requirements proposed by regulatory authorities in other jurisdictions, including the U.S.
- *Direction to auditors*. A firm must direct its independent auditor, in writing, to conduct any audit or review required by the applicable securities regulator.
- *Annual and interim financial reporting*. Audited financial statements must be delivered within 90 days of the firm's financial year and interim financial statements must be delivered within 30 days of the first, second and third interim periods. A completed Form 93-102F1 *Calculation of Excess Working Capital* must be delivered by all registered firms annually and by registered derivatives dealers quarterly.
- *Compliance policies and procedures*. A firm must have written policies and procedures that establish a system of controls and supervision sufficient to

ensure that the firm and each individual transacting in or advising on OTC derivatives complies with applicable securities legislation.

- *Risk management policies and procedures*. A firm must have written policies and procedures that establish a system of controls and supervision to monitor and manage the risks associated with its OTC derivatives related activity. These risk management policies and procedures must address certain specified matters and also must require the reporting of a material change to risk exposures or a material breach of a risk limit to the firm's Derivatives UDP and board of directors. Firms must conduct an independent review of their risk management systems at least every two years.
- *Minimum standards for confirmation of terms and certain agreements*. Minimum standards are set out for:
    - the confirmation of the material terms of each OTC derivative transacted with or for an investor;
    - a written agreement with the investor that establishes a process for determining the value of the OTC derivative unless the transaction is cleared through a qualifying clearing agency; and
    - a written agreement that establishes a process for resolving a dispute when there is a discrepancy about the material terms of the OTC derivative or the value of the OTC derivative.
- *Business continuity and disaster recovery plans*. Firms must establish and maintain business continuity and disaster recovery plans, and review these plans at least annually.
- *Portfolio reconciliation and compression*. There are specified standards with respect to the portfolio reconciliation and compression to be carried out by firms.
- *Books and records*. A firm must keep complete records of all its OTC derivatives, transactions and OTC derivatives advising activities.

Registered Individual Requirements and Obligations

The duties and obligations of the Derivatives UDP and the Derivatives CCO are largely consistent with their NI 31-103 counterparts; however, there are a few points of note.

The Derivatives UDP is required to report certain instances of non-compliance with the Derivatives Registration Rule or with other securities legislation to the applicable securities regulator. A senior derivatives manager has a similar duty under the Business Conduct Rule.

Each of the Derivatives CCO and the Derivatives CRO must submit annual reports to the firm's board of directors. The CSA notes that it may periodically request a copy of these reports to monitor the compliance and implementation of the Derivatives Registration Rule and, from a broader perspective, of OTC derivatives regulations.

The Derivatives CRO's role largely mirrors that of the Derivatives CCO, except that the Derivatives CRO's domain is the firm's risk management system. For instance, he or she is responsible for, among other things, establishing, maintaining and applying policies and procedures for assessing and managing risks related to the firm and reporting to the Derivatives UDP any circumstance indicating that the firm, or any individual acting on its behalf, may be in material non-compliance.

The Exemptions: Firm and Individuals

Firm Registration Exemptions

The Derivatives Registration Rule provides two types of exemptions:

- Exemptions from the registration requirement. While a firm may be exempt from the registration requirement, it will be subject to the terms and conditions of the exemption.
- Exemptions from specific requirements under the Derivatives Registration Rule. The firm is still required to register and comply with each registration requirement where an exemption does not apply.

Exemptions from the registration requirement

- *Derivatives end-user exemption*. A derivatives end-user (*e.g.*, an entity that trades derivatives for its own account for commercial purposes) is exempt from the requirement to register as a derivatives dealer, subject to specific terms and conditions, including that it does not solicit or otherwise transact in an OTC derivative with, for or on behalf of a non-EDP.
- *Derivatives dealers with a limited notional amount*. If a dealer's aggregate month-end gross notional amount under OTC derivatives does not exceed a prescribed threshold it is exempt from the requirement to register, subject to specific terms and conditions, including that the dealer does not solicit or otherwise transact in an OTC derivative with, for or on behalf of a non-EDP. The threshold for a firm that is a derivatives dealer only in respect of "commodity derivatives" is $1 billion. The threshold for all other derivatives dealers is $250 million. Notional amount is determined based on the dealer's aggregate month-end gross notional amount under outstanding OTC derivatives. The CSA has proposed, and asked for comments on, two proposed methodologies for determining notional amount.
- *Foreign (non-Canadian) derivatives dealers and derivatives advisers*. A firm that has its head office or principal place of business in a specified foreign jurisdiction and that is subject to, and complies with, regulatory requirements that are equivalent to specified requirements, is exempt from the requirement to register, subject to specific terms and conditions. These terms and conditions include that the firm does not advise, solicit or otherwise transact in an OTC derivative with, for or on behalf of a non-EDP, that it provides certain disclosure of its non-resident status to its investors and that it provides a submission of jurisdiction notice to the applicable securities regulator. In addition, the firm must promptly notify the regulator of instances of material non-compliance with a requirement or guideline of the applicable foreign jurisdiction and undertake to the applicable securities regulator to provide the regulator with prompt access to its books and records upon request.

Exemptions from specific requirements for certain registered firms

If a derivatives firm must register, it may be able to benefit from exemptions from specific requirements under the Derivatives Registration Rule, where the CSA has identified that these specific requirements are equivalent to requirements found in other Canadian or foreign legislation. Such exemptions are available to IIROC dealer members, Canadian financial institutions that are regulated by a federal or provincial prudential authority and certain foreign derivatives dealers and advisers, subject to specific terms and conditions.

Individual Registration Exemptions

Even where a firm is registered under the Derivatives Registration Rule, certain of its individuals who transact or advise on OTC derivatives may not have to be registered as Derivatives Dealing Reps or Derivatives Advising Reps. Exemptions apply where an individual solely transacts with or advises an affiliated entity of the firm, other than an affiliated entity that is an investment fund, or where the individual solely transacts with or advises EDPs. The latter exemption is not available to an individual who acts as an adviser for a managed account.

Interaction with Other Derivatives and Securities Legislation

Staff of certain jurisdictions of the CSA are considering whether modifications to securities legislation, including act amendments, are needed to implement the Derivatives Registration Rule. In particular, “accredited counterparties” are exempt by law from the registration requirement under the Québec *Derivatives Act* when transacting with each other in OTC derivatives. The implementation of the Derivatives Registration Rule is, therefore, subject to the Québec National Assembly’s decision to revoke this exemption.

Further, Ontario’s *Securities Act* provides that certain specified financial institutions are exempt from registration. As a result, the Ontario Securities Commission (the “OSC”) will not register those financial institutions when they act as derivatives dealers or advisers in the Ontario market. The OSC has identified a gap that relates to the registration of individual representatives of financial institutions and is currently assessing potential regulatory solutions that are available to address this gap.

Contact Us

If you have any questions about the Derivatives Registration Rule, 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 — Regulatory and Transactions — at Global Capital's Americas Derivatives Awards every year since the inception of these awards.

1 The definition of EDP has been revised from the version first proposed in the Business Conduct Rule to take into account comments received on the Business Conduct Rule. For instance, the term “commercial hedger” is now referenced in the definition of EDP. Commercial hedgers are subject to a lower financial threshold to qualify as EDPs when compared to other, non-individual, persons or companies.

2 Restricted derivatives dealer and restricted derivatives adviser categories of registration are also contemplated in the Derivatives Registration Rule. These categories would be employed where specific circumstances warrant unique or tailored requirements for a firm and its business.

3 “Risk Manager Designation” means a designation qualifying an individual as a financial risk manager by the Global Association of Risk Managers or professional risk manager by The Professional Risk Managers’ International Association.

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