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Canada's first derivatives business conduct rule coming into force

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On September 28, 2024, National Instrument 93-101 (the Instrument) will come into force, introducing a business conduct regime for participants in the Canadian OTC derivatives market. All firms engaged in dealing in or advising on over-the-counter derivatives in Canada—including firms otherwise relying on exemptions from dealer/adviser registration requirements—will need to comply with the Instrument or seek to rely on an available exemption.

What you need to know

- On September 28, 2024, Canada's first derivatives business conduct regime will come into force, imposing obligations on derivatives dealers and advisers across Canada.
- Certain client representations and waivers contemplated by the Instrument will need to be obtained from derivatives counterparties prior to certain cut-off dates as detailed below. Firms can include these items in their standard ISDA Canadian representation letters[1].
- Firms that are exempt or otherwise excluded from the registration requirements in Canada with respect to dealing in or advising on derivatives are not automatically exempt from the Instrument and may need to file for additional exemptions.
- For firms that deal exclusively with sophisticated "eligible derivatives parties", core provisions in the Instrument will still apply to transactions with these parties.

Background

One of the takeaways from the 2008 global financial crisis was the clear need to address systemic weaknesses in over-the-counter (OTC) derivatives markets. In 2009, G20 countries set about remedying this by agreeing to implement several key reforms aimed at making derivatives markets safer and more transparent: these reforms included trade reporting of OTC derivatives to data repositories, higher capital and minimum margin requirements for non-cleared OTC derivatives, and central clearing of all standardized OTC derivatives. To date, Canada had remained the only G20 country not to adopt a business conduct regime to govern the country's OTC derivatives markets.

To address this gap, the Canadian Securities Administrators (CSA) published Consultation Paper 91-407 *Derivatives: Registration* in 2013, which outlined a proposed business conduct and registration regime for participants in Canada's derivatives markets. Following comments on the Consultation Paper, the CSA published proposed National Instrument 93-101 for the first time in 2017, which set out the proposed structure of what would be Canada's first business conduct regime governing OTC derivatives markets[2].

On September 28, 2023, the CSA published the finalized version of Multilateral Instrument 93-101 *Derivatives: Business Conduct* (the Instrument), which introduced a new business conduct regime for participants in the Canadian OTC derivatives markets. The Instrument was originally published as a Multilateral Instrument since British Columbia did not initially adopt its contents. On July 11, 2024, the British Columbia Securities Commission published advanced notice of its adoption of the Instrument, including certain B.C.-specific provisions, subject to approval by British Columbia's Minister of Finance. As a result, the Instrument will become a National Instrument (and thereby apply across Canada) as of September 28, 2024.

Application

Firms subject to the Instrument

The Instrument will apply to any person or company that is (a) in the business of trading derivatives (derivatives dealers) or advising others with respect to trading derivatives (derivatives advisers), or (b) otherwise required to register as a derivatives dealer or adviser under securities legislation. The Instrument does not apply to dealing with or advising an affiliated entity unless that affiliated entity is an investment fund.

To assess whether a derivatives firm qualifies as either a derivatives dealer or derivatives adviser under the Instrument, securities regulators will conduct a holistic assessment of the firm's activities. For a derivatives dealer, this assessment will consider several factors, including: whether the company is acting as a market maker, directly or indirectly carrying on the activity with repetition, regularity or continuity; facilitating or intermediating transactions; directly or indirectly soliciting in relation to transactions; providing derivatives clearing services; or transacting with the intention of being compensated. In addition, regulators will consider whether the company is engaging in activities similar to those of a derivatives dealer, including carrying out any activities which a reasonable person would perceive as similar to the activities set out above.

The analysis of whether a company or person is acting as a derivatives adviser will involve evaluating whether the person or company is "in the business" of advising others in relation to derivatives or derivative strategies. Where a firm's advising activity is incidental to the firm's primary bona fide business, securities regulators may not consider it to be advising for a business purpose. While this is a highly fact-specific analysis, individuals engaged in any of the following will generally be considered to be in the business of advising others in relation to derivatives:

- registered advisers that provide advice to an investment fund/person/company in relation to derivatives or derivatives trading strategies;
- registered advisers that manage an account for a client and make trading decisions in relation to derivatives or derivative trading strategies;
- an investment dealer that provides advice on derivatives; or
- a person or company that recommends a derivative or derivative trading strategy as part of a general solicitation by an online derivatives trading platform.

Firms that are in doubt as to whether the Instrument will apply to their activities should consult with legal counsel.

What is a derivative under the Instrument?

In order to determine what qualifies as a derivative under the Instrument, market participants will need to defer to the derivatives product determination rule applicable in the jurisdiction where their trading and/or advising will take place. While the qualification of derivatives is largely harmonized between them, there are four separate product

determination rules that govern the classification of derivatives across Canada:

- **Ontario:** Ontario Securities Commission Rule 91-506 *Derivatives: Product Determination*
- **Québec:** Regulation 91-506 respecting Derivatives Determination
- **Manitoba:** Manitoba Securities Commission Rule 91-506 *Derivatives: Product Determination*
- **All Other Provinces/Territories:** Multilateral Instrument 91-101 *Derivatives: Product Determination*

Classification of derivatives parties

Much like National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*[3], the Instrument takes a tiered approach with respect to which protections will be extended to dealings with derivatives parties, depending on a party's level of sophistication—as assessed, for example, by their financial resources, access to professional advice, and ability to otherwise protect themselves through contractual negotiation with the derivatives firm.

There are generally three categories of derivatives parties distinguished in the Instrument:

- Eligible Derivatives Party (EDP) that is not an individual or eligible commercial hedger[4]: An EDP captures, among others, Canadian financial institutions, derivatives and investment dealers registered under securities legislation of a jurisdiction of Canada, a qualifying clearing agency, and a person or company, other than an individual, that has net assets of at least $25 million. Dealings with counterparties that qualify as EDPs are exempt from the Instrument except for certain "core" requirements as set out below.
- An EDP that is either an individual or eligible commercial hedger that has waived protections: Where an EDP is also an individual or eligible commercial hedger, the party can provide a confirmation that it "waives protections provided in the Instrument". Although there is no prescribed form for this waiver, it must specify the protections to which it applies and must be provided in a "clear and meaningful" manner. This waiver can be included in account opening documentation or master trading agreements and can be in a form similar to the waiver used by permitted clients to waive suitability obligations under National Instrument 31-103. Derivatives firms have an obligation to remind EDPs signing a waiver that they have the option of obtaining independent legal advice. Firms have until September 28, 2025 to obtain this waiver.
  Derivatives firms should also be aware that where they are dealing with an EDP that is both an individual[5] *and* an eligible commercial hedger, the derivatives firm will have additional obligations to identify and document the nature of the EDP's business and the related commercial risks they are seeking to hedge.
- Non-eligible Derivatives Party ("Non-EDP"): a derivatives party that is not an EDP. Provisions of the Instrument described below that apply to non-EDPs are equally applicable to EDPs that are individuals or eligible commercial hedgers that have not waived any of the protections afforded to them under the Instrument.

Certain "core" requirements in the Instrument apply to all derivatives parties and cannot be waived. These include rules governing fair dealing, conflicts of interest, know your derivatives party, the handling of complaints, and tied selling. Sections of the Instrument relating to compliance (Part 5 – Division 1), recordkeeping (Part 5 – Division 2), segregation of assets (Part 4 – Section 25), and the delivery of transaction information (Part 4 – Subsection 28(1)) also apply to dealings with all derivatives parties.

When dealing with Non-EDPs, firms have additional obligations, including the obligation to conduct a suitability analysis (and to collect sufficient information to conduct that analysis), deliver adequate relationship disclosure information, provide pre-transaction disclosure in the required form and with the required content, provide adequate derivative party statements, and to comply with rules regarding entering and disclosing referral arrangements to derivative parties.

Transition period

Although the Instrument will take effect on September 28, 2024, there is a five-year transition period to allow derivatives firms to qualify a derivatives party as an EDP. During the transition period, derivatives firms can rely on a written representation (the Transition Representation) from a derivatives party confirming that they qualify as an EDP on the basis of one of the criteria set out in section 50(2) of the Instrument which includes:

- permitted clients (as defined in National Instrument 31-103);
- non-individual accredited investors (Ontario);
- an eligible contract participant (as defined in the U.S Commodity Exchange Act);
- an accredited counterparty (Quebec);
- a qualified party (in a number of jurisdictions);
- a financial counterparty (as defined under Article 2(8) of the European Market Infrastructure Regulation); and
- a non-financial counterparty (as defined in Article 2(9) of, and which exceeds clearing thresholds pursuant to Article 10(4)(b) of, the European Market Infrastructure Regulation).

On September 12, 2024, the CSA published additional guidance in Staff Notice 93-302 *Frequently Asked Questions About National Instrument 93-101 Derivatives: Business Conduct* (the FAQ). The FAQ provides practical guidance, clarifying various concepts in the Instrument and offering details on where and how firms seeking to rely on exemptions in the Instrument can make their filings. With respect to the Transition Representation, the FAQ clarifies that firms are expected to use their professional judgement when assessing whether they have sufficient information to reasonably establish that a client qualifies under one of the criteria in section 50(2) in order to rely on the Transition Representation. Firms can accomplish this by, for example, having a representation in a derivatives contract asking a counterparty to confirm their status under one of the criteria set out in section 50(2).

A firm can rely on the Transition Representation until September 28, 2029, so long as the representation was made prior to September 28, 2024. If the firm does not obtain a Transition Representation by the cut-off date, it must certify the derivative party's status as an EDP based on one of the criteria set out in the definition.

Exemptions for foreign derivatives dealers and advisers

Of particular interest to foreign derivatives dealers and advisers currently relying on the International Dealer Registration Exemption (IDRE) and/or International Adviser Registration Exemption (IARE) available under National Instrument 31-103[6], Part 2 of the Instrument specifies that the Instrument also applies to a person or company who is otherwise exempt or excluded from the requirement to register as a derivatives dealer or adviser. As a result, firms currently relying on the IDRE, IARE or a comparable exemption under the Quebec Derivatives Act will either need to file for an additional exemption (as detailed below) or comply with the applicable requirements under the Instrument with respect to any dealings with Canadian derivatives parties.

Fortunately, the Instrument does provide exemptions[7], subject to certain conditions, for foreign derivatives dealers and advisers whose head office or principal place of business is in an approved foreign jurisdiction[8]. These conditions include the requirement that the person or company limit their dealings in Canada to EDPs and that they are otherwise subject to, and comply with, the laws of their foreign jurisdiction in their dealings with Canadian derivatives parties. Where the dealer/adviser is relying on an exclusion/exemption (including discretionary relief) in its foreign jurisdiction, or where there is no regulatory regime which applies to its activities with a derivatives party in its foreign jurisdiction, these exemptions may not be available.

Coordinated Blanket Order 93-930

In response to industry feedback, the CSA published Coordinated Blanket Order 93-930 (the Blanket Order) on July 25, 2024, which provides two temporary exemptions from certain requirements in the Instrument. Specifically, the Blanket Order expands the definition of an EDP to include investment funds managed or advised by a foreign equivalent to a Canadian registered investment fund manager or adviser. As a result, foreign investment funds will also qualify as EDPs and will receive the same treatment under the Instrument as domestically managed funds[9].

The Blanket Order also provides an exemption for 2024 from the requirement for senior derivatives managers to provide a compliance report to the board of directors of their derivatives firm at least once every calendar year in accordance with Section 32(3) of the Instrument. Senior derivatives managers will need to ensure that the period from the effective date of the Instrument to the end of 2024 is addressed when they submit their compliance reports in 2025.

Conclusion

For firms acquainted with the compliance framework set out in National Instrument 31-103, the Instrument will feel like a familiar read, as many of the same concepts and principles have been borrowed and applied to the derivatives context. There are, however, certain concepts and obligations which are idiosyncratic to the Instrument that will require specific attention from firms. As with the recent client-focused reforms, securities regulators may conduct regulatory sweeps of firms in the near future to assess compliance with the Instrument. The authors are available to discuss any facet of the Instrument, including its application to your firm's particular circumstances.

FOOTNOTES

To discuss these issues, please contact the author(s).