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CSA publish final derivatives business conduct rule

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On September 28, 2023, the Canadian Securities Administrators (CSA) published a final derivatives business conduct rule after an extensive consultation process. Multilateral Instrument 93-101 Derivatives: Business Conduct (the rule) and associated Companion Policy 93-101CP Derivatives: Business Conduct (the CP)[1] establish a market conduct regime for derivatives dealers and advisers (derivatives firms) in Canadian derivatives markets. Notwithstanding Canada's ongoing efforts to introduce a comprehensive derivatives regulatory regime following the 2008 global financial crisis, to date Canada has remained the only G20 country that has not yet implemented a business conduct rule for derivatives markets. In publishing the final rule, the CSA intends to implement a business conduct regime that is largely harmonized within Canada and with the regimes of other key derivatives markets such as the U.S. and the E.U. Many of the business conduct obligations are similar to those applicable to securities dealers and advisers under National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103) but adapted to reflect differences in derivatives markets.

In advance of the effective date of the rule on September 28, 2024 (the Effective Date), derivatives firms will need to review and update their derivatives operations to ensure compliance with the rule by the Effective Date. This article summarizes the provisions of the rule and key compliance considerations for derivatives firms.

Application of the rule

Regulated firms

The rule applies to the derivatives business conduct of a person or company that falls within the meaning of a "derivatives dealer" or "derivatives adviser" and individuals acting on their behalf, regardless of whether they are registered or exempted from registration in a Canadian province or territory.[2] The CSA have adopted a "business trigger" test analogous to that applied to securities dealers and advisers under NI 31-103. In particular, a person or company is a derivatives dealer or derivatives adviser under the rule if it is either in the business of trading derivatives or in the business of advising others in respect of derivatives, respectively. While certain market participants, such as banks with extensive derivatives dealing and advising activities, clearly may be captured under the business trigger test, other

market participants will need to holistically evaluate their derivatives activities and the non-exhaustive list of factors set forth in the CP to determine whether they would be considered in the business of trading or advising in derivatives and therefore subject to the rule. Factors that the CSA have indicated in the CP may be relevant include:

- **Acting as a market maker**: routinely standing ready to transact derivatives by responding to requests for quotes or making quotes available to others, and typically being compensated for providing liquidity through spreads, fees or other compensation.
- **Directly or indirectly carrying on the activity** with repetition, regularity or continuity: frequent or regular transactions, even if not the person's primary endeavour.
- **Facilitating or intermediating transactions**: facilitation of trading or intermediation of transactions between third-party counterparties.
- **Transacting with the intention of being compensated:** transacting and receiving, or expecting to receive, any form of compensation for transaction activity.
- **Directly or indirectly soliciting in relation to transactions:** contacting someone by any means, including communications that offer (i) derivatives transactions, (ii) participation in derivatives transactions or (iii) services related to derivatives transactions (although communication with a potential counterparty without intention or expectation to be compensated may not necessarily satisfy this factor).
- **Engaging in activities similar to a derivatives adviser or derivatives dealer:** carrying out similar activities to the foregoing.
- **Providing derivatives clearing services:** allowing third parties to clear derivatives through a clearing agency in furtherance of a trade by a person that would typically be an intermediary in the derivatives market.

For purposes of the rule, a derivatives dealer's or derivatives adviser's client or counterparty, as applicable, is referred to as a "derivatives party".

Exempt entities

Qualifying clearing agencies, the Government of Canada, the government of a jurisdiction of Canada, the government of a foreign jurisdiction, the Bank of Canada, a central bank of a foreign jurisdiction, the Bank for International Settlements and the International Monetary Fund are exempt from the rule. However, derivatives firms dealing with or advising these entities may still be subject to the rule. The rule also does not apply to a derivatives firm dealing with or advising an affiliated entity (other than an affiliated investment fund).

Eligible derivatives parties

The rule entails a two-tiered approach for derivatives market participant protection based on whether a derivatives party is an "eligible derivatives party" (EDP) or "non-eligible derivatives party":

- Core provisions discussed below apply when a derivatives firm is dealing with or advising *any* derivatives party regardless of EDP status.
- Additional obligations (i) apply when a derivatives firm is dealing with or advising a non-EDP and (ii) apply but may be waived when a derivatives firm is dealing with or advising an

EDP that is an individual or an eligible commercial hedger.

The EDP concept is analogous to an "eligible contract participant" under the U.S. *Commodity Exchange Act* and related CFTC regulations, and reflects the CSA's view that, because of their sophisticated nature, regulatory oversight, financial resources or experience, certain derivatives parties do not require the full set of business conduct protections afforded to other derivatives parties. EDPs include:

- Canadian financial institutions (Schedule I or II banks, trust and loan companies, credit unions, insurance companies, etc.)
- Registered derivatives dealers and derivatives advisers, securities and commodity futures advisers and investment dealers.
- Regulated pension funds and their wholly-owned subsidiaries.
- Foreign entities analogous to any of the foregoing.
- Canadian governments and their crown corporations, agencies or wholly-owned entities, foreign governments and their agencies and Canadian municipalities, public boards or commissions.
- Canadian and foreign trust companies acting on behalf of managed accounts.
- Registered or authorized securities and commodity futures advisers and derivatives advisers acting on behalf of managed accounts.
- Investment funds managed by a registered investment fund manager under Canadian securities legislation or advised by an adviser registered or exempted from registration under Canadian securities or commodity futures legislation.
- Non-individuals with net assets of at least C$25 million, as shown on their most recently prepared financial statements.
- "Commercial hedgers" who have represented such status in writing (Commercial Hedgers)[3],
- Individuals with beneficial ownership of financial assets[4] that have an aggregate realizable value before tax, but net of any related liabilities, of at least C$5 million (High Net Worth Individual EDPs).
- Non-individuals whose obligations under derivatives are fully guaranteed or otherwise fully supported (e.g., by a letter of credit) under a written agreement by one or more EDPs (other than a Commercial Hedger or High Net Worth Individual EDP)
- Qualifying clearing agencies.

If a derivatives party is an EDP, a derivatives firm is generally subject to less onerous business conduct obligations with respect to its dealings with such EDP. The only non-waivable obligations that will apply are the following (the Core Provisions):

- Division 1 [*General obligations towards all derivatives parties*] of Part 3 [*Dealing with or advising derivatives parties*] of the rule (fair dealing, conflicts of interest, know your derivatives party, handling complaints and tied selling)
- Sections 24 [*Interaction with other Instruments*] and 25 [*Segregating derivatives party assets*]
- Subsection 28(1) [*Content and delivery of transaction information*]
- Part 5 [*Compliance and recordkeeping*]

However, if the EDP is (i) an individual or (ii) a Commercial Hedger who does not fall under

any other EDP category (an Eligible Commercial Hedger), the remaining obligations in the rule apply by default to such EDP unless such EDP has provided a written waiver of the protections provided in the rule that specifies which protections are waived. The CP clarifies that an individual or Commercial Hedger may waive specific provisions for a specific derivative, a class of derivatives or all derivatives and, while there is no obligation to update the waiver after it is made, the EDP may withdraw any waiver in whole or in part.

Business conduct obligations

The rule imposes extensive business conduct obligations on derivatives firms that will apply at various points during the relationship with their derivatives parties, from pre-transaction through transaction execution, lifecycle and post-termination.

General obligations

Certain of the Core Provisions are treated as fundamental obligations and therefore apply to *all* derivatives parties, regardless of EDP status. In particular, all derivatives firms will need to comply with the following obligations:

- **Fair Dealing:** Act fairly, honestly and in good faith with a derivatives party.
- **Conflicts of Interes***t*: Identify all material conflicts of interest, and material conflicts of interest that the derivatives firm in its reasonable opinion would expect to arise, between the derivatives firm (including each individual acting on behalf of the derivatives firm) and a derivatives party.
- **Know your derivatives part***y*: Obtain facts necessary to verify the identity of a derivatives party (including certain beneficial owners thereof), status as an insider of a publicly traded issuer, possession of material non-public information, and derivatives party's creditworthiness (if the derivatives firm will have credit risk). All such information must be kept current.
- **Handling complaints:** Document and promptly respond to each complaint made about any product or service offered by the derivatives firm or an individual acting on its behalf.
- **Tied selling**: Not impose undue pressure on or coerce a person or company to obtain a derivatives-related product or service from a particular person or company as a condition of obtaining another product or service from the derivatives firm.

Additional obligations

In addition to the foregoing general obligations, derivatives firms will have other business conduct obligations, including:

- **Information and suitability obligations**: Obtain sufficient, and keep current, information regarding the derivatives party's needs and objectives and ensure that a specific derivative and transaction are suitable for a derivatives party.
- **Referral arrangement obligations**: Document in writing the terms of any referral arrangement and all referral fees, verify the qualifications of any person or company receiving the referral, and disclose prescribed information to the referred derivatives party.

- **Disclosure and reporting obligation*s***:
  - Before transacting with or advising a derivatives party, deliver prescribed relationship disclosure information relating to the account, fees and the relationship with the derivatives firm.
  - Disclose in writing, at least 60 days before becoming effective, new fees or other account charges and fee increases.
  - For derivatives dealers, before transacting a type of derivative, deliver prescribed pre-transaction disclosure, including information regarding the type of derivative, the risks and material characteristics thereof, and a prescribed statement as to the risk of leverage in derivatives transactions.
  - For derivatives dealers, a daily valuation of each outstanding derivative on each business day.
  - For derivatives advisers, a quarterly valuation statement, unless the derivatives party requests the valuation statement be delivered monthly.
  - For non-resident derivatives dealers, a prescribed statement as to, among other things, its foreign "home" jurisdiction and that there may be difficulty enforcing legal rights against it.
  - For derivatives dealers, a written confirmation of a transaction (which, for non-EDPs, must include prescribed transaction-specific information).
  - Quarterly derivatives party statements (i.e., account statements) with respect to transactions during the quarterly period and other account-related details (e.g., description of all posted collateral, cash balances in the account, all other derivatives party assets held by the derivatives firm, etc.)
- **Segregation and use of derivatives party assets**: Unless a derivatives firm is subject to and complies with certain specified legislation and guidelines regarding customer assets/collateral,[5] the derivatives firm must:
  - Segregate derivatives party assets and derivatives positions from the property and derivatives positions of the derivatives firm and other persons.
  - Hold initial margin at a "permitted depository".[6]
  - Not use or invest initial margin without the derivatives party's written consent and unless the derivatives firm has entered into a written agreement with the derivatives party whereby the derivatives firm assumes all losses resulting from its investment or use of initial margin.
- **Compliance and recordkeeping obligations:**
  - Establish, maintain and apply policies and procedures to ensure compliance with securities legislation relating to trading and advising in derivatives, the management of risks relating to derivatives activities, and competency of individuals acting on behalf of the derivatives firm.
  - For derivatives dealers, designate an individual as a "senior derivatives manager" (a SDM) for each derivatives business unit of the firm. SDMs must supervise the derivatives-related activities of the applicable derivatives business unit to ensure

compliance and address any non-compliance. Annual compliance reports must be submitted by SDMs to the board of directors (or equivalent) of the firm.

- For derivatives dealers, timely report any non-compliance to the applicable securities regulator where the non-compliance creates or created a risk of material harm to a derivatives party or capital markets or is part of a pattern of material non-compliance.
- Enter into an agreement with the derivatives party that establishes all the material terms governing the relationship between the derivatives firm and the derivatives party.
- Maintain records of its derivatives transactions and advising activities, including prescribed records. Records must be kept for seven years (Eight years in Manitoba) from the date they are created.

Exemptions

Even if a firm satisfies the business trigger test and therefore qualifies as a derivatives dealer or derivatives adviser subject to the rule, a complete or partial exemption from the rule may be available. Key exemptions include the following:

- **End-user**s: A complete exemption from the rule is available for firms which do not (i) solicit or otherwise transact with, for or on behalf of, or advise (other than general advice in accordance with the advising generally exemption discussed below) a non-EDP, (ii) regularly make or offer to make a market in a derivative, (iii) regularly facilitate or otherwise intermediate transactions for another person, or (iv) facilitate the clearing of a derivative through the facilities of a qualifying clearing agency for another person. However, the exemption is not available if the firm is registered under derivatives, securities or commodity futures legislation in any Canadian jurisdiction or in an equivalent category in its foreign "home" jurisdiction.
- **Foreign derivatives dealers and advisers:** A complete exemption from the rule is available for foreign derivatives dealers and derivatives advisers whose head office or principal place of business is in an eligible foreign jurisdiction[7] if the derivatives dealer or derivatives adviser (i) transacts only with, for or on behalf of, or advises, EDPs, (ii) is registered, licensed or authorized under the securities, commodity futures or derivatives legislation of the Eligible Foreign Jurisdiction to conduct the derivatives activities in that jurisdiction that it conducts with the local Canadian EDPs, (iii) complies with such securities, commodity futures or derivatives legislation, (iv) provides the applicable Canadian securities regulator with access to its books and records relating to activities conducted with a local Canadian derivatives party, (v) provides written disclosure to the derivatives party as to, among other things, its foreign "home" jurisdiction and that there may be difficulty enforcing legal rights against it, and (vi) submits to the applicable Canadian securities regulator a Form 93-101F Submission to Jurisdiction and Appointment of Agent for Service of Process. For derivatives advisers, notice of reliance on the foreign derivatives adviser exemption during any 12-month period preceding December 1 of a year must be given to the applicable Canadian securities regulator by December 1 of that year.[8]

- **CIRO investment dealers and Canadian financial institutions**: Partial exemptions from prescribed provisions of the rule are available to investment dealer members of the Canadian Investment Regulatory Organization (CIRO) and certain prudentially regulated Canadian financial institutions if they are subject to and comply with specified corresponding conduct and other regulatory rules/provisions issued by CIRO or their applicable prudential regulator, and they promptly notify the applicable Canadian securities regulator of material non-compliance with any such rules/provisions.
- **General notional amount exemption**: There is an exemption from the rule (other than the fair dealing, conflicts of interest and delivery of transaction information obligations) for derivatives dealers who (i) do not solicit or otherwise transact with, for or on behalf of, or advise (other than general advice in accordance with the advising generally exemption discussed below) a non-EDP and (ii) do not have an aggregate month-end gross notional amount of certain outstanding derivatives in any of the previous 24 months that does not exceed C$250 million.[9]
- **Commodity dealer notional amount exemption**: There is an exemption from the rule (other than the fair dealing, conflicts of interest and delivery of transaction information obligations) for derivatives dealers who (i) are derivatives dealers solely as a result of commodity derivatives transactions, (ii) do not solicit or otherwise transact with, for or on behalf of, or advise (other than general advice in accordance with the advising generally exemption discussed below) a non-EDP and (iii) do not have an aggregate month-end gross notional amount of certain outstanding commodity derivatives in any of the previous 24 months that does not exceed C$10 billion.[10] However, this exemption does not apply in respect of any cryptoasset commodity derivative.
- **Advising generally:** There is complete exemption from the rule for a firm that provides advice that is not purported to be tailored to the needs of the recipient of the advice. If the advice includes a recommendation of a specific derivative, class of derivative or underlying interest thereof in which the firm or certain prescribed related parties has a financial or other interest, that interest must be disclosed concurrently with the advice.
- **Foreign derivatives sub-advisers:** A complete exemption from the rule is available for derivatives sub-advisers whose head office or principal place of business is in an Eligible Foreign Jurisdiction if (i) the derivatives adviser or derivatives dealer have entered into a written agreement with its derivatives parties agreeing to be responsible for losses from the derivatives sub-adviser's failure to exercise its prescribed duty of honesty and good faith and duty of care, (ii) the derivatives sub-adviser is registered, licensed or authorized in a category of registration, or operates under an exemption from registration, under the securities, commodity futures or derivatives legislation of the Eligible Foreign Jurisdiction and such legislation permits the derivatives sub-adviser to carry on the activities in that jurisdiction that registration as a derivatives adviser would permit it to carry on in the local Canadian jurisdiction, and (iii) the derivatives sub-adviser engages in the business of a derivatives adviser in the Eligible Foreign Jurisdiction.
- **Registered advisers under securities or commodity futures legislation**: Partial

exemptions from prescribed provisions of the rule are available for derivatives advisers that are registered as an adviser under securities legislation (i.e., NI 31-103) or Ontario and Manitoba commodity futures legislation if the firm complies with the corresponding business conduct provisions of applicable securities or commodity futures legislation. This exemption is intended to allow these registered advisers to extend their existing compliance systems to cover their derivatives activities with their clients. Appendix B to the CP contains guidance regarding the provisions of the rule that do and do not apply to these registered advisers when relying on this exemption.

Transition period

The rule will become effective on September 28, 2024. In recognition of the extensive work that derivatives firms will need to undertake to re-paper their derivatives parties depending on their EDP status and to ensure compliance with the business conduct obligations, the CSA have provided for a five year transition period expiring on September 28, 2029 (the Transition Period). During the Transition Period, derivatives firms which have received a representation from a derivatives party that it falls within any of the following categories (the EDP Transition Categories) may treat such derivatives party as an EDP for purposes of the rule:

- A "permitted client" as defined in 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* (Québec.)
- A "qualified party", as defined in certain local securities commission rules/orders of Alberta, British Columbia, Manitoba, New Brunswick, Nova Scotia and Saskatchewan.
- An "eligible contract participant", as defined in the U.S. *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*

Derivatives firms should review their existing trading documentation to determine whether their derivatives parties have provided any such representation to ensure the firm will be able to treat such derivatives parties as EDPs and only be subject to the Core Provisions with respect to such derivatives parties during the Transition Period. With respect to any derivatives party that is an individual or an Eligible Commercial Hedger that nevertheless require a written waiver to be treated as an EDP, and subject to less onerous business conduct obligations, derivatives firms will have one year from the Effective Date (i.e., September 28, 2025) to obtain the required waiver from the derivatives party to continue to treat such derivatives party as an EDP after such one year period expires.

Existing transactions entered into before the Effective Date where a derivatives firm has determined that the derivatives party falls within one of the EDP Transition Categories are exempt from the rule other than the fair dealing obligation.

Takeaways

The final rule is a significant step in Canada's evolving derivatives regulatory regime that will bring Canada in line with other G20 jurisdictions. In advance of the Effective Date, both Canadian and foreign derivatives dealers and derivatives advisers should carefully review their derivatives activities to determine whether and how the rule will apply to them and

determine their next steps for compliance. Firms should expect there to be ongoing efforts by industry associations, such as ISDA, to assist with the implementation of the rule over the next year and during the Transition Period.

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[1] The final rule has been published as a multilateral instrument applicable in all provinces and territories except British Columbia. However, in the CSA's notice of publication, the CSA note that the British Columbia Securities Commission intends to adopt substantially similar rules at a later date, at which time the multilateral rule would be converted to a national instrument applicable in all jurisdictions.

[2] Note that, while the CSA have proposed a National Instrument 93-102 Derivatives: Registration (the Registration Rule) most recently in 2018, there is currently no derivatives registration rule in force in Canada, except in Québec pursuant to the *Derivatives Act* (Québec).

[3] The Commercial Hedger category of EDP is intended to apply to businesses entering into derivatives to hedge a *bona fide* risk in their business related to (i) an asset that the person owns, produces, manufactures, processes or merchandises, or reasonably anticipates owning, producing, manufacturing, processing or merchandising (e.g., a commodity producer seeking to manage seasonal commodity price fluctuations), (ii) a liability that the person incurs or reasonably anticipates incurring (e.g., a corporate borrower seeking to hedge floating interest rate risk under its credit facilities), or (iii) a service that the person provides, purchases or reasonably anticipates providing or purchasing.

[4] Defined by reference to National Instrument 45-106 Prospectus Exemptions (NI 45-106) which is used for "accredited investor" exemptions from prospectus requirements in securities legislation and encompasses cash, securities and a contract of insurance, a deposit or an evidence of a deposit that is not a security for the purposes of securities legislation.

[5] Sections 3 to 8 of National Instrument 94-101 Derivatives: Customer Clearing and Protection of Customer Collateral and Positions; Guideline E-22 *Margin Requirements for Non-Centrally Cleared Derivatives* of the federal Office of the Superintendent of Financial Institutions; *Guideline on margins for over-the-counter derivatives not cleared by a central counterparty* of Québec's Autorité des marchés financiers; and National Instrument 81-102 Investment Funds.

[6] Includes a Canadian financial institution (i.e., a Schedule I or II bank, trust and loan company, credit union, etc.), a qualifying clearing agency, the Bank of Canada or a central bank of prescribed jurisdictions, and a banking institution or trust company in prescribed jurisdictions with a minimum of C$100 million shareholders' equity.

[7] At present, these include: Australia, Brazil, Hong Kong, Iceland, Japan, Republic of Korea, New Zealand, Norway, Singapore, Switzerland, the U.S., the U.K. and any member country of the E.U. (the Eligible Foreign Jurisdictions)

[8] This is not required for a foreign derivatives adviser that complies with the filing and fee payment provisions applicable to an unregistered exempt international firm under Ontario

Securities Commission Rule 13-502 Fees.

[9] The notional amount is calculated by:

- For a local Canadian derivatives dealer, determining the notional amount of all its transactions (minus inter-affiliate transactions) and adding the notional amount of all transactions of its affiliates that are a Canadian local counterparty (minus their inter-affiliate transactions); and
- For a foreign derivatives dealer, determining the notional amount of all its transactions *with Canadian local counterparties* (minus inter-affiliate transactions) and adding the notional amount of all transactions of its affiliates that are a Canadian local counterparty (minus their inter-affiliate transactions).

[10] The notional amount is calculated in the same manner as for the general notional amount exemption discussed above, but solely with respect to commodity derivatives.